

**ECONOMIC &
MARKET ANALYSIS:
ASIA PACIFIC**

Asia-Pacific Economics/Strategy

24 July 2006

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Asia Economic Outlook and Strategy

North Korea's Reforms

- **As North Korea's economic reforms have proceeded further than widely recognized, an imminent collapse of the regime looks highly unlikely**
- **Recent recoveries of many risky assets may reflect too sanguine a reading of global risks**
- **Asian growth is likely to continue to consolidate on weakening US demand, a dimming tech outlook, higher rates and rising oil prices**
- **An acceleration of Chinese growth supports the case for further policy tightening, including faster appreciation of the currency**
- **We recommend receiving in Asian local market curves while global uncertainties persist. Equity markets are likely to fall further before finding support**

Asia Pacific

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North Korea's reform progress in many areas, especially enterprise independence, exchange rates and free markets, is broadly comparable to that in China in the late 1980s. Commitments to continuous economic reforms appear to be strong and broad-based. Thus, an imminent collapse of the regime looks highly unlikely. A reduction of political difficulties could significantly boost the benefits of reform, which, in turn, may reduce risk for the region

Too soon for an “all-clear”

After recent rallies, current asset valuations may incorporate too sanguine a reading of global risks. Recent recoveries reflect, in part, more moderate expectations for monetary policy in key countries. But policy may have a way to go, especially in China amid continued strong growth. Given these uncertainties, recent recoveries in asset markets may be somewhat shaky. Markets may not fully reflect emerging geopolitical risks.

Rates, oil and China

While financial markets began to stabilize following the recent fallout, new risks emerged for Asia, including changing rate expectations, skyrocketing oil prices and overheating in China. We continue to expect Asian growth to moderate in the second half, outside China and India, on weakening US demand, a dimming tech outlook, higher interest rates and rising oil prices. Central banks are likely to stay cautious in the near term, especially with regard to currencies. An acceleration of Chinese growth supports the case for further tightening, but we think risks to our upwardly revised GDP forecasts are still on the upside.

Asian local markets: Receive in August while uncertainties persist

Over August, global/regional uncertainties seem unlikely to be fully settled to the satisfaction of markets. This argues for rangebound Asian FX markets, but on the rates side, we think overall conditions have turned to favor receiving. In FX, tactically we are prepared for more US\$ strength, but strategically we are still positioned for a juncture in which Asian currencies rebound. By contrast, on both tactical/strategic grounds, we like the new receive view for Asia.

Macro Overview

- **Recent recoveries of many risky assets may reflect too sanguine a reading of global risks**
- **While financial markets began to stabilize following the recent fallout, new risks emerged for Asia, including changing rate expectations, skyrocketing oil prices and overheating in China**
- **We continue to expect Asian growth to moderate in the second half, outside China and India, but central banks are likely to stay cautious in the near term, especially with regard to currencies**
- **An acceleration of Chinese growth supports the case for further tightening, but we think risks to our upwardly revised GDP forecasts are still on the upside**

Too Soon for an “All-Clear”

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The strong positive reaction across a range of markets to Chairman Bernanke's testimony on July 19 suggests that many market participants are increasingly confident that fundamental risks are receding. But it may be too early to draw this conclusion. Much of the underlying economic uncertainty that contributed to the sell-offs in a range of markets in May and June remains unresolved. While we expect only moderate further tightening of monetary policy across an array of countries and regions, the risks around that base case are weighted toward higher rates than we or markets currently expect. In addition, the outbreak of conflict in Israel and Lebanon, which has caused many markets to correct somewhat in the last nine days, could have wider implications for the global economy as it raises the risk of oil supply disruptions. These developments suggest that current valuations may incorporate too sanguine a reading of global risks.

Despite the decline that started in May, values of risky assets are generally healthy. Equity prices in some markets fell by 20% or more (see Figure 4). But given the magnitude of earlier gains, equity prices in a number of these markets remain roughly where they were six months ago and substantially higher than they were a year ago. Likewise, credit spreads widened since early May, but the recent move was smaller than in the sell-offs of 2004 and 2005 (see Figure 5). Moreover, spreads for investment-grade emerging market borrowers remain significantly tighter than the average since the beginning of 2004. Markets for a number of key commodities also have shown surprising resilience. For example, copper prices are down about 10% from their late-May peak, but they are still up 70% from early March.

The recent recoveries of asset markets probably reflect, at least to some degree, more moderate expectations for the path of monetary policy in key countries. Forward interest rates have generally fallen in major markets since late June. Our base case forecast continues to be that in most countries moderate tightening of monetary policy should be sufficient to contain emerging inflationary pressures. But it may take some time to confirm this basic conclusion.

Changing rate expectations

Market expectations about the US Fed funds rate have been unstable recently. The softer-than-expected FOMC statement in late June reduced the probability of an August rate hike from close to 100% to barely above 50%. Chairman Bernanke's testimony on July 19 restated the Fed's earlier message, i.e., while growth has probably moderated to a non-inflationary path, lingering inflation remains a concern. We maintain our base case that the Fed funds rate will still peak in late August at 5.5%, although the actual FOMC decision will depend on economic data in the coming weeks. In Europe and Japan, we actually upgraded our forecasts for year-end rates. We think the ECB will likely hike two more times, one in early August and the other before the end of the year, with the policy rate peaking at 3.25%. BoJ may also increase the policy rate one more time before the end of the year, following the first change on July 14.

Against this global backdrop, we think short-term interest rates in some Asian economies may also rise further. However, Asian growth momentum has already started to moderate. In addition, outside Indonesia, the Philippines and Vietnam, actual inflation rates are still below, or within the ranges of, the official targets/forecasts (see Figure 6). But even in Indonesia and the Philippines, inflation rates have been falling for the past months. In some economies such as China, Hong Kong, India, Korea, Malaysia and Taiwan, CPI picked up recently.

Figure 6. Inflation Targeting in Asia

Economy	Targeted Price Index	Government Target or Forecast		Actual Core/Headline CPI	
		2005	2006	Most recent	3-months prior
China	No official inflation targeting policy	3.0-3.5	3.0	1.4 (May 06)	0.9
Hong Kong	No official inflation targeting policy	1.5	2.3	2.9 (May 06)	1.6
India	No official inflation targeting policy	5.0	5.0-5.5	4.4** (May 06)	4.1**
Indonesia	CPI	5.5-8.6	7.0-9.0	15.6 (May 06)	17.9
Korea	Core CPI (ex. ag and oil)	2.5 to 3.5 (BOK)	3.0 (BOK)	2.0* (May 06)	1.7*
Malaysia	No official inflation targeting policy	2.8	3.5-4.0	3.9 (May 06)	3.2
Philippines	CPI	5-6	4-5	6.9 (May 06)	7.6
Singapore	CPI	0 - 1	1 - 2	1.1 (May 06)	1.2
Taiwan	No official inflation targeting policy	2	1.8	1.58 (May 06)	0.98
Thailand	Core CPI (ex. ag and oil)	4-4.5	2.0-3.0	2.7* (May 06)	2.7*
Vietnam	No official inflation targeting policy	8.0	##	7.6 (May 06)	7.4

Note: * Core CPI, ** Wholesale Price Index. ## In Vietnam, the authorities hope to keep inflation rate below real GDP growth rate.

Source: Citigroup estimates.

In summary, current and expected changes in growth momentum and inflationary pressure do not provide strong support for substantial further hikes of policy rates in the region. China is an exception in this case where the economy shows some signs of overheating. Oil prices remain a key risk. And, in a number of economies such as China and India, adjustments of domestic oil prices could also lead to higher inflation rates. Therefore, the magnitudes of further increases in Asian policy rates are likely to be limited (see Figure 7).

A surge in oil prices in the OEF model also boosts inflation in many emerging countries. India, the Philippines, Indonesia and Thailand stand out as showing relatively more inflation. Incidentally, these are also the “high inflation” economies in Asia. If the inflationary impact of high oil prices materializes, then the central banks in these countries may need to raise interest rates more than we currently expect.

Accelerating Chinese growth

China's acceleration of GDP growth to 11.3% in the second quarter from 10.3% in the first quarter, despite the measures introduced earlier to cool down investment, surprised the markets. The pickup of growth momentum began from the beginning of the year, on renewed political incentives before the expected change of local governments and the start of many new projects mandated by the Five-Year Plan. The authorities had already started to take steps to slow investment activities, including industrial consolidation through administrative measures, hikes in lending rates by an average of 27 basis points in April, and an increase in the reserve requirement ratios twice, in June and July, by 1 percentage point. Cooling the property market also became a policy target.

Most of these measures, however, haven't been very effective, judging from not only GDP acceleration in the second quarter but also faster paces of investment and production in June. And one of the key reasons was probably too much liquidity in the system, which effectively reduces the cost of capital. Because of expectations of currency appreciation, capital inflows remain very strong. Foreign exchange reserves reached US\$941.1bn at the end of June. The central bank's ability to sterilize, however, declined recently due to very low market interest rates but increased pressure on commercial banks to improve their financial performance. Too much liquidity and too low market interest rates seriously reduce the effectiveness of any tightening policies by reducing the cost of capital.

The market now expects another 27bp hike in the base lending rate within the coming month or so. We think this is likely. The government may also reduce export tax rebates. But we also think the actual effect of such a modest move on credit growth is likely to remain limited. To rein in investment, the authorities are likely to also focus on efforts in two areas – administrative measures and liquidity controls. PBOC's hike of reserve requirement last Friday, the second one within almost a month, confirmed the central bank's determination to tighten the liquidity. To reduce liquidity, the central bank is likely to increase open market sales of short-term paper. That both requires, and could lead to, higher market interest rates, which would, in turn, add further pressure on the currency. We continue to expect faster appreciation of the renminbi in the coming months, with expected appreciation by 7.5%.

The market is concerned about further tightening in China. And while we recently raised our GDP forecast for 2006 on the strong performance in the first half of the year, we maintain our expectation of a modest slowdown in the second half due to the expected tightening policies, moderation of external demand and some renewed risks such as oil. But in the near term, any fears about a possible hard landing are likely to be overdone. Most government officials still believe that China needs strong growth to create jobs and that the current risks are more of structural imbalances than overheating. Any risk to our GDP forecast is likely to be on the upside.

Investment implications

While some of the risks are new, they are consistent with our view of moderating growth momentum. We expect the average Asian GDP growth to slow from 7.9% in the first half of the year to 6.7% in the second half, on slower US growth, cautious tech outlook, higher interest rates and likely much higher oil prices.

It may also be important to point out that currently downside risks also look limited. In both the US and China, we expect only a modest slowdown, not a hard landing, of the economies. In the financial markets, the worst may be behind us.

Of the three components of GDP, we think the contribution of net exports is likely to weaken visibly. And slowing exports and higher interest rates could hurt investment, unless government spending on infrastructure investment steps up significantly. Consumption could outperform in relative terms.

Central banks in the region may stay cautious in the very near term, especially with regard to the currencies. But we still see chances of the Indonesian rupiah and Thai baht outperforming the forward markets (see Figure 10). Recently, we also shifted our overweight recommendation for the Indonesian sovereign back to neutral but attached an overweight position on Vietnam's external debt.

Figure 10. Asian Debt and Currency Markets — Local and External Market Recommendations

Country	Local Market Instruments ^a		Sovereign Foreign-Denominated Bonds
	Currency	Interest Rates	
Asia			
China			Underweight
India	–	–	NA
Indonesia	+		Neutral
Korea			Underweight
Malaysia			Underweight
Philippines		+	Neutral
Taiwan		–	NA
Thailand	+		NA
Vietnam			Overweight

^a For currencies and interest rates; "+" the instrument is likely to outperform forward markets; "–" the instrument is likely to underperform forward markets over the next three months, where market forwards are available; otherwise the symbols represent directional calls. NA Not Applicable.

Source: Citigroup.

Impressions on North Korea's Reforms

- While political issues continue to dominate international discussions, North Korea's economic reforms have probably proceeded much further than what has been widely recognized
- Reform progress in many areas, especially enterprise independence, exchange rates and free markets, is broadly comparable to that in China in the late 1980s
- Recent changes in economic systems and associated payoffs suggest that, in the short term, any internal-factor-triggered collapse of the regime is highly unlikely
- Commitments to continuous economic reforms and internationalization, which began in July 2002, appear to be strong and broad-based
- A reduction of political difficulties could significantly boost the benefits of such reform efforts, which, in turn, may reduce risks for the region, particularly South Korea and Japan

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Food supply situation improved

Yiping Huang recently visited North Korea in a personal capacity, together with Peter Drysdale, an economics professor from the Australian National University. During the weeklong visit, they had meetings with policymakers and economists from various ministries, including the Cabinet Office, and paid visits to state-owned companies, banks, joint ventures, universities and some other cultural sites.

Several years ago, Yiping worked with a former colleague at the Australian National University, Heather Smith, on North Korea's famine problem.¹ Between 1988 and 1997, North Korea's grain output declined by nearly 50%, which, according to various estimates, caused total deaths of between 500,000 and 2,000,000. Their analysis suggested that, of the total output decline, about 69% was due to a reduction in inputs, especially tractors and fertilizers, and the remaining 31% was because of a deterioration in productivity, possibly attributable to bad weather and a collectivization policy. The sudden shortage of inputs was a result of the collapse of the former Soviet Union and the Eastern Block.

¹ Heather Smith and Yiping Huang. 2000. 'Trade disruption, collectivization and food crisis in North Korea,' Paper presented at the Conference *Achieving High Growth: Experience of Transitional Economies in East Asia*, August 2000, Canberra, Australia.

Since then, the authorities have made various efforts to improve the food situation, through the implementation of certain responsibility farming systems, an improvement in seed varieties and the extension of double cropping. Imports of oil and fertilizer, especially from China and South Korea, increased significantly. These, alongside increases in international food aid, helped to lift the food supply to levels of normal nutrition for the North Korean population.² North Korea does not look well positioned to achieve self-sufficiency in food. Ultimately, food imports on commercial terms are necessary to meet domestic demand. To do that, however, North Korea would need to develop a stronger export sector.

July 2002 reforms

In July 2002, North Korea launched a major wave of economic reforms. In retrospect, it has made significant progress in the following areas:

- ▶ Improving the independence of decision-making for enterprises
- ▶ Increasing the role of free markets, especially for non-essential goods
- ▶ Liberalizing the exchange rate policy
- ▶ Opening the economy

The most obvious evidence of progress in economic reform was the “marginalization” of the State Planning Commission (SPC). In recent years, the importance of the SPC has declined significantly, with its key roles shifting from detailed planning of economic activities to scenario analyses.

Managers of state-owned enterprises (SOEs) have gained freedom in determining output mixes and even product prices. Managers of profitable SOEs also have the freedom to hire employees from universities and other companies. While the base salary grades are still set by the government, which vary according to industries, professions, education and experience, managers can decide on benefits and bonuses. At some IT companies that we visited, the amounts of benefits and bonuses are well above 50% of base salaries. There is no taxation system for domestic enterprises. But most SOEs have a profit-retention plan, which allows companies to retain 40-50% of the total profits for their own development or compensation. The government also has set up microfinance joint ventures to promote the development of small and medium enterprises.

Free markets also play an important role in resource allocation. Some international analysts estimate that currently about 90% of farm surpluses (i.e., total output minus farm household consumption) go directly to free markets. The Public Distribution System (PBS), which used to handle all farm surpluses, is now mainly for distributing international aid products.³ Not long ago, there were reports about North Korea re-introducing food rations. To us, this sounded more like providing subsidies to urban residents, as most urban households still buy additional food from the markets. But, currently, market prices are only marginally higher than state prices.

² Peter Drysdale, “The Economics of North Korea Settlement”, *APEC Economics Newsletter*, October 2005, Australian National University, Canberra.

³ Stephan Haggart and Marcus Noland, 2005, *Hunger and Human Rights: The Politics of Famine in North Korea*, U.S. Committee for Human Rights in North Korea., Washington DC.

This not only suggests that food supply conditions have improved but also that price subsidies to urban residents are not significant.

Exchange rate policy is another area that experienced significant reform. After the July 2002 reforms, the North Korean won depreciated sharply, from the official won 165 per euro to the current market rate of 2,200. Today, North Korea has three exchange rates. The first is the official rate, which is still at 165, but is used for official accounting purpose only. The second is the black market rate. And the third is called a corporate exchange rate, which tracks the black market rate very closely and is used for most corporate transactions.

The authorities also took steps to increase exports and attract foreign investment. They introduced laws on joint ventures and on foreign investment. Corporate income tax rates are set at 10-25%, which can be reduced to 0% for between two and seven years for foreign invested firms. The government also set up industrial/special economic zones in border areas with South Korea and China in order to boost trade and investment.

Experiences in the above areas suggest that North Korea's economic reforms are probably broadly comparable to those in China in the mid- to late-1980s. In some areas, such as foreign exchange rate policy, North Korea is probably already beyond the China of the early 1990s.

The farming system is one key area that has not experienced any significant reform. In the second half of the 1990s, North Korea introduced some elements of a group responsibility system, ie, the collectives were broken up into smaller groups that operated as relatively independent farms. That was, however, reversed in recent years. The explanation we were given was that de-collectivization did not generate productivity gains due to high levels of agricultural infrastructure and mechanization (as the small sizes of farms hindered the realization of scale efficiency).

Basis for another East Asian miracle?

Actual progress in economic reforms has been way beyond our expectations. North Korea's key risks are still more political than economic, as evidenced by the recent missile tests. But there is a lot more happening in the economy than most North Korea watchers would admit. Some analysts would simply dismiss North Korea's reforms as a means of survival. But reform, including that in China or the former Soviet Union, begins as ways of survival. The crucial questions are: whether such reform efforts will lead to a significant improvement in efficiency, income and welfare and whether the continuous progress eventually becomes self-sustaining.

It's too early to predict if North Korea may soon join the other rapidly growing East Asian neighbors. But it has already laid a good basis for achieving strong economic development if reforms continue. The two dynamic and large neighbors, South Korea and China, could serve as important launch pads for North Korea's economy. They may even play roles for North Korea similar to the roles played by Hong Kong for China in its early stage of reform. Interestingly, North Korea is rich in natural resources and has a well educated population. It has an 11-year compulsory free education policy, and its literacy rate is close to 100%, compared to only 20% some 60 years ago.

The main obstacles for North Korea's economic prospects are political, both domestic and international. Unlike the experiences of China, efforts to increase exports and investment generated very limited results, even though North Korea's trade with China and South Korea expanded by 40-50% annually. Other countries have not really expanded their economic links with North Korea significantly, either because of a lack of information or because of political constraints. These have seriously reduced the benefits of reform. Recently, for example, products produced in North Korea's Kaesong Industrial Zone became a sticky issue during negotiations for the US-Korea FTA. If products containing parts made in Kaesong have to be excluded in the FTA, this would discourage South Korea's investment in the North and would further discourage North Korea's integration into the international economy.

It might be in the best interests of the international community to help support and facilitate economic reforms in North Korea, while carefully managing political risks. Past experiences suggest that economic integration and income growth are often the best ways to reduce political and policy uncertainties. Therefore, economic engagement may increase the chance of continuous economic reforms in North Korea and, at the same time, reduce risks for everybody else.

Strategy — Asian Currencies and Interest Rates

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- **Global concerns about macro and US Fed credibility seem unlikely to be resolved to the satisfaction of markets in August**
- **This suggests somewhat rangebound Asian FX markets, where tactically we are prepared against more US\$ strength, but where strategically we expect Asian currencies to rebound later in the year**
- **On both our base case and an alternative case (in which growth slides) scenarios, receiving in Asian yield curves has become considerably more attractive; we suggest looking at India**
- **Market fears appear clustered around: (1) sliding growth; (2) unbridled inflation; and (3) a stumbling Fed**
- **We think you can't have (1) and (3) nor (1) and (2); we cannot rule out (2) and (3), but believe inflation manageability ultimately eliminates (2) and by implication also (3)**

Asian Local Strategy Summary

Over August, it seems unlikely that global/regional concerns about inflation and growth and about the credibility of new US Federal Reserve Chairman Bernanke can be fully settled to the satisfaction of markets. This will be particularly true if the usual holiday lull and recent risk aversion on the part of many investors prevail.

All of this argues for somewhat rangebound Asian FX markets in the near term (no fireworks in our forecast grid for the month ahead, below), but on the rates side we do think overall conditions have turned to favor receiving (more explanation at the end of this strategy). In FX, tactically we are prepared for more short-term momentum plays in the direction of US\$ strength against Asia (motivations similar to what held at the end of August last year⁴), but strategically we are still positioned for a juncture in which widespread inflation fears ultimately prove unfounded and the US Fed scrapes through a tough first year under its new chairman. By contrast, on both tactical/strategic grounds we like the new receive view for Asia. Perhaps the key risk will be lingering uncertainty over the Fed, which could give rise to market volatility under thin liquidity and prices veering away from fundamentals.

⁴ *Asia Economic Outlook and Strategy*, 29 August 2005, pp. 15-24.