

Equity Research Asia/Pacific
Economics Report
Economics Team

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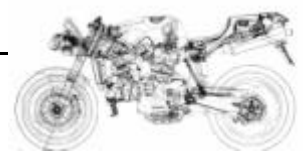
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- China: Still Overheated
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May 2005

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The Motorcycle Overheats

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Shifting Balances of Power

	China	India	Japan	US	Euro-zone
GDP (\$ current price)					
1974	137	91	460	1,553	
1984	308	204	1,267	4,036	
1994	542	307	4,795	7,232	6,054
2004	1,718	607	4,667	11,995	9,400
2014E	6,000	1,500	5,000	20,000	14,000
Trade (\$ current price)					
1974	15	10	117	202	
1984	54	24	304	552	
1994	237	52	671	1,172	1,233
2004	1,155	170	1,020	2,281	2,686
2014E	3,000	680	1,500	3,500	3,500

Source: CEIC, Morgan Stanley Research

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China: Export/Investment Lead Growth



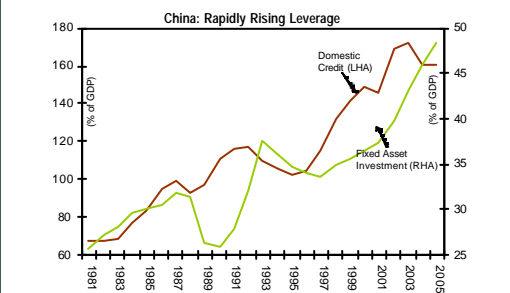
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China: Debt Drives Fixed Investment



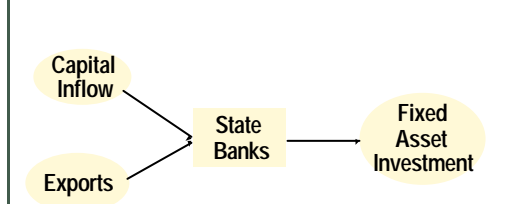
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China: Liquidity Depends on New Money



Overinvestment leads to low RoA and, hence, high NPLs and low liquidity in the banking system. The banking system needs new money to stay liquid. The fixed exchange rate automatically liquefy the system by turning deflation from overcapacity into exports and more deposits. The state-owned banking system and the fixed exchange rate regime are at the heart of China's development model.

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The 'Motorcycle' Growth Model

US Consumer (Asset-based consumption) provides Cheap Money and Cheap Goods to Chinese Investor (Debt-financed investment). Chinese Investor provides Natural Resources and Capital Equipment to Resource Exporters and Equipment Exporters. Resource Exporters provide Natural Resources to Chinese Investor. Equipment Exporters provide Capital Equipment to Chinese Investor.

Source: CEIC, Morgan Stanley Research

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The Commodity Multiplier

- The most important multiplier of the Fed monetary policy is through China to inflate commodity prices, reflating emerging economies in general. Most emerging economies have been experiencing de-industrialization due to competition from China, India and Vietnam, which is deflationary. Rising commodity prices offer extra income to boost demand.
- Rising commodity prices redistribute income from developed economies (e.g., Europe and Japan) to less-developed economies that can use money more productively. Hence, the global economy grows faster.

Source: CEIC, Morgan Stanley Research

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Is the Motorcycle Model Sustainable?

- Fifteen years ago, socialist block countries abandoned planning and joined the global economy. Their combined labor force is three times the total OECD labor force.
- The new entrants have high productivity and low wealth and, therefore, must work hard to accumulate wealth. This causes wage deflation in OECD economies.
- The global economy can continue to grow when the rich OECD economies abandon wealth accumulation and focus on consumption. The net household wealth of the OECD countries is about \$100 trillion. The wealth-based consumption model is sustainable. The world needs Europe and Japan to follow the US to consume more and invest less.

- China is investing and exporting. The global economy needs to broaden this front to India, Vietnam and other cheap labor economies.

Source: CEIC, Morgan Stanley Research

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But the Model Is Bubble-Prone

- The integration of rich OECD with poor ex-socialist economies is bubble-prone. The presence of massive cheap labor in the global economy keeps down inflation, and excessive money supply tends to inflate asset markets.
- The declining price of imports from Asia has kept down the prices of goods in the US. Cheap and plentiful Asian goods and IT have allowed big-box retailers to increase economies of scale in distribution, which has kept down distribution costs.
- From mid-1990s, the US CPI ceased to respond to monetary growth. However, the stock market became very sensitive to the money supply. In the past five years, the property market has also been responding to the money supply.

Source: CEIC, Morgan Stanley Research

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Low CPI, High Property Price in Asia Too

- China's surplus labor is an anchor for low inflation despite loose monetary conditions. This is truer close to home. Real interest rates in Asia are near historical lows but inflation is also close to all-time lows. When real interest rates were this low in the previous two cycles, inflation was in double digits compared with 3% now.
- But property prices have responded well to low real interest rates. Hong Kong stands out in this regard. Most mainland cities are also experiencing rapid rises in property prices. Korea and Taiwan have joined the trend to a lesser degree.

Source: CEIC, Morgan Stanley Research

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Central Banks Have Supplied Too Much Money

- Money supplies in major global economies have risen much faster than GDP since 1997. The main cause is the deflationary shock from the Asian Financial Crisis and the investment-led boom in China.
- The excessive liquidity creation has led to a tech bubble, property bubble, China bubble and commodity bubble. It has been one long and big bubble since 1997.

Money Supplies Are Decelerating				
(YoY % chg.)	US	Euro-zone	Japan	
	M2M	M1	M1	M1
1981-91	10.0	8.2	5.5	8.1
1991-2001	8.2	7.2	8.1	8.1
2002	12.9	7.7	27.4	7.5
2003	7.3	10.7	7.5	7.5
2004	3.8	9.3	4.0	4.0

But Levels Are Still Too High				
(% of GDP)	US	Euro-zone	Japan	
	M2M	M1	M1	M1
1980	30.8			29.0
1991	40.6	23.2	26.7	26.7
1997	40.5	26.9	34.9	34.9
2002	57.5	33.7	68.1	68.1
2003	56.8	36.2	71.0	71.0
2004	55.5	38.0	73.5	73.5

Source: CEIC, Morgan Stanley Research.
Note: M2M stands for money with zero maturity as money market funds account for a big part of the US monetary system. M1 is all most of the money supply in Europe and Japan.

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Big US Trade Deficit Signals Over Stimulation

- The Fed panicked over deflation after the tech bubble burst and supplied too much money and waited too long to raise interest rates. Low inflation had misled the Fed on how loose its monetary policy had become.
- The money went into the housing market first. House prices have risen twice as fast since 2000 than previously. New York's house prices have doubled and California's are up 65% since 2000. Household housing wealth has increased by 53% or \$6 trillion since 2000 vs. a 20% rise in nominal GDP.
- The housing wealth explosion has fueled a consumption boom that has caused the US trade deficit to skyrocket. Australia and the US have experienced similar trends.

	US	UK	Japan	EU zone	Asia	Oil	Windsfall
1992	-96	-23	1.6	-17	94		-69
1993	-133	-20	0.0	23	95		-114
1994	-166	-17	-3.2	28	101		-141
1995	-174	-19	-4.2	42	70		-114
1996	-191	-21	-6.6	41	15		-90
1997	-197	-20	1.8	40	83		-99
1998	-247	-36	-5.4	36	233		-231
1999	-346	-47	-9.8	47	215		-30
2000	-452	-50	-4.7	46	186		179
2001	-427	-59	1.7	46	192		70
2002	-483	-70	-5.4	55	175		68
2003	-548	-78	-15.2	62	193		165
2004	-668	-106	-18.0	70	206		415

Source: CEIC, Morgan Stanley Research.
Note: Oil windfall is the revenue above \$22/barrel for exporters in Africa and South America, used to finance foreign aid.

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Easy Money Has Caused Excessive Risk-Taking

- The liquidity bubble began to spill into other asset classes in 2003. Spreads between sovereign and high-risk debt have narrowed sharply, the yield curve has flattened considerably, and volatilities have reached historical lows in many major asset classes. The main reason is that investors ignore risks and chase yields.
- The Fed's policy of 'measured pace' in raising interest rates is the primary reason for the excessive risk-taking as it offers comfort to speculators on policy risk. This is why the Treasury yield is still lower than when the Fed began to raise interest rates.

Source: CEIC, Morgan Stanley Research.

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The Overheated Motorcycle Must Cool Down

- The Fed has injected too much money into the new global growth machine - US consumption and Chinese investment. The signs of overheating are the large and rising US trade deficit and China's excess investment.
- The sustainable level for the US trade deficit should be 3% of GDP or half as high as it is currently. The sustainable level of fixed investment in China should be 35% of GDP, not 50%. To achieve these levels, the Fed must tighten to lower property prices and increase treasury yields.
- Europe and Japan will have to step up consumption to prevent a global recession when China and the US rest.

Source: CEIC, Morgan Stanley Research.

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Inflation Shock Could Trigger Collapse

- Stimulus causes Chinese demand for oil to skyrocket. Because the oil supply is relatively fixed in the short term, prices can rise much more quickly than demand. As speculators see the tight balance and buy to increase inventory demand, prices increase even more.
- Even though the share of energy costs in the US economy has declined sharply from two decades ago, oil prices could still rise fast enough to put inflation above 4%. This could provoke a sharp response from the Fed. This would be one way for the bubble to end.
- But the global oversupply of labor is likely to keep inflation low long term.

Source: CEIC, Morgan Stanley Research.

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Oil Is the Key

The Fed's monetary policy triggered a massive export boom and hot money flows for China. The two developments have led to an investment bubble in China since 2002, which has exaggerated China's oil demand. The hedge fund bubble pushed prices beyond the level justified by Chinese demand. Oil is a double bubble.

Financial speculation is pushing up oil prices. Cheap money is the fuel for speculation. And, unlike the property or stock market bubble, an oil bubble actually causes inflation. Hence, the Fed's monetary policy becomes unsustainable.

The Fed's talking about inflation may scare away speculators for a short period. The speculation may return to force the Fed to increase rates quickly.

Source: CEIC, Morgan Stanley Research.

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What Could Be Next?

Bigger Bubble
(10Y T at 2%, US housing prices up a further 30%, another US demand-led party)

Protectionism
(recession in Europe and Japan, US low growth with more jobs)

US Bubble
(If the US acts alone)

Dollar Crash
(deflation in Europe and Japan, stagflation in US, 10Y T at 10%)

US Deflation
(The Fed increases interest rates to crush bubble, 10Y T at 1.5%, US dollar strong, multiyear recession)

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What Next?

Japan
(Decreasing savings rate by allowing property prices to fall by a further 50% to transfer wealth to young from old)

Europe
(Increasing property prices by decreasing transaction costs to boost consumption)

US Bubble
(If the US works with China, Europe and Japan to create a new order)

China
(Increasing Rmb by 20% in exchange for better trade protection, timetable for reforming financial sector to float currency)

Global Balance
(Bringing China into G-7 and turning it into Big-4 with one seat for Europe)

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Asia/Pacific: Strong Liquidity But Cycle Peaked

May 2005

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Asian Export Cycle Turns Down

- Asia has experienced above 20% export growth rate for 30 months - the longest boom in history. Exceptional monetary stimulus by the Fed and the massive location of production to China are reasons for such a strong trade boom.
- The cycle is turning down as the cyclical indicators in G-7 economies are turning down. The combined exports of China, Taiwan and Korea slowed to 24% growth in Jan-Feb 05 from 32% in 2004.
- Exports may decelerate 1.5 percentage point a month and may reach single-digit growth by the end of 2005.

Source: CEIC, Morgan Stanley Research

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Outsourcing May Cushion Downturn

- Europe and Japan are showing strong import growth but weakening GDP. Outsourcing still seems to be increasing penetration in these two economies. In contrast, outsourcing has always been strong in the US and its import strength is still consistent with its GDP.
- The biggest worry is protectionism. Income in Europe and Japan is likely to deteriorate further while import penetration continues to rise. The combination may increase political pressure for protectionism.

Source: CEIC, Morgan Stanley Research

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Consumption Remains Resilient

- Export boom and hot money have liquefied every economy in Asia. Property markets have moved up in all major economies. Hence, consumption is likely to remain resilient.
- The inflation rate appears to have stabilized and is running at 2%. In a globalized economy, inflation appears to be a global rather than local phenomenon. Asia's inflation is running at about 3%. The source of inflation is the higher energy cost.

Source: CEIC, Morgan Stanley Research

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Liquidity Is Still Strong

Asia may be experiencing a fourth wave of liquidity inflow in this cycle. The first wave was in 2002 due to strong exports. It ended with the SARS crisis. The second wave came after the end of the SARS crisis and ended with China's tightening in April 2004. The third wave was evident after China decided not to tighten further in September 2004 and ended in January 2005. The liquidity inflow appears to have revived since the Chinese New Year in February 2005.

Asia's foreign exchange reserves were rising by \$2 billion a day in 4Q04, paused in January 2005 and probably picked up again in February.

Source: CEIC, Morgan Stanley Research

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Liquidity Inflow Has Nine Lives

Financial markets have clearly felt the strong liquidity in the past year. But traditional liquidity indicators (e.g., US MZM, or M2 in Europe or Asia) have all been quite weak across the world. Traditional explanations may be insufficient.

There are three anomalies in the global economy: (1) the large and rising US trade deficit, (2) huge windfalls for oil exporters, and (3) large and rising Asian F/X reserves. The oil windfalls have not gone into the global banking system, according to BIS.

The global money multiplier may have risen sharply as, driven by low interest rates, high net-worth individuals have bought into derivative products.

Source: CEIC, Morgan Stanley Research

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It Takes a Shock for Liquidity to Recede

- Negative real interest rates in Asia are caused by strong exports and hot money inflow. Raising interest rates could help but not end negative interest rates as more hot money inflow would decrease the effectiveness of monetary policy in the region.
- The liquidity bubble will deflate if China deflates, the Fed raises interest rates quickly, or there is a shock (e.g., a oil supply shock).

Source: CEIC, Morgan Stanley Research
Note: China's short-term rate is 7D interbank bond repo rate, Hong Kong's 1M interbank rate, Taiwan's 7D interbank rate, and Korea's overnight call rate.

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China: A Big Property Bubble

May 2005

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Overheating Continues

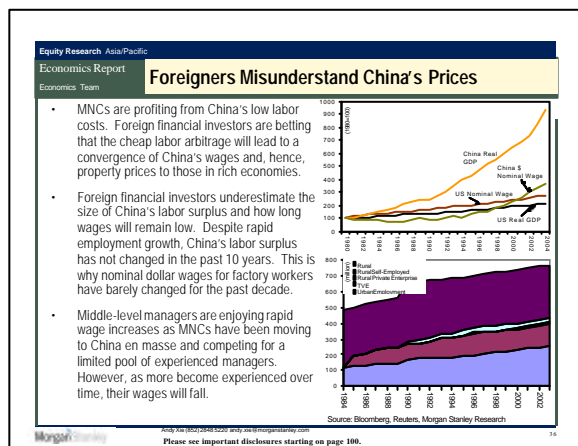
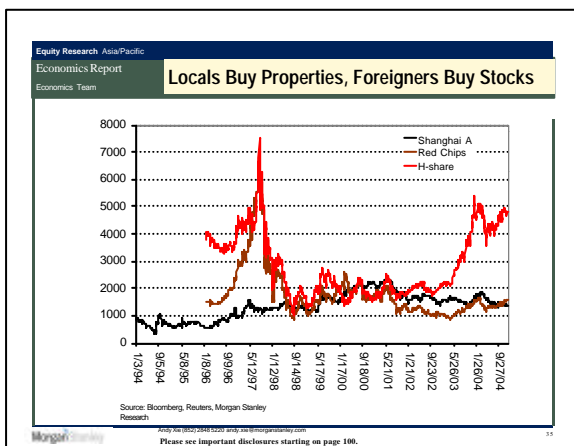
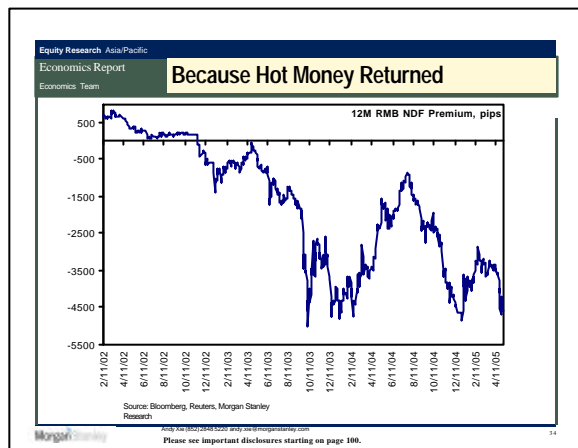
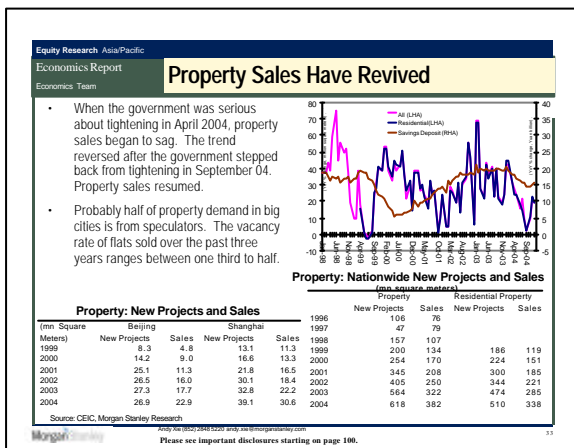
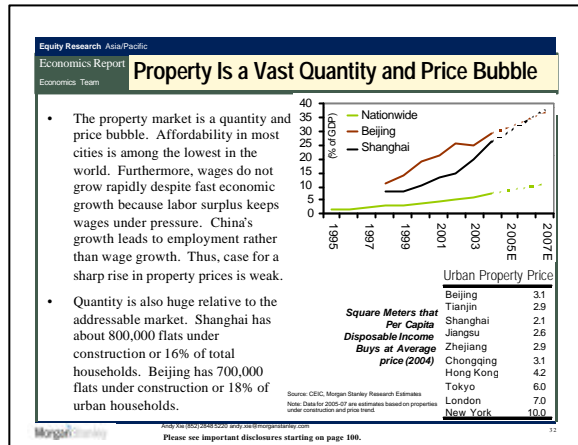
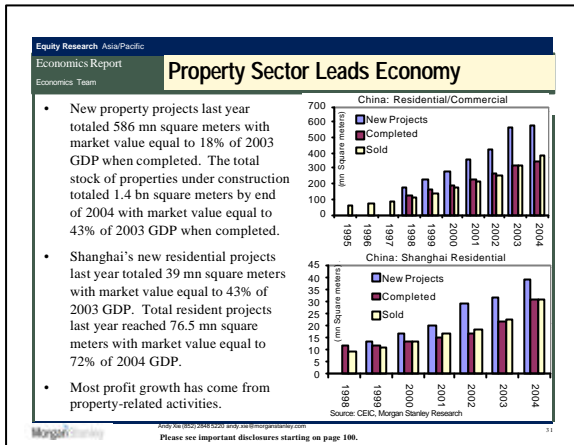
China: Overheating Continues into 2005

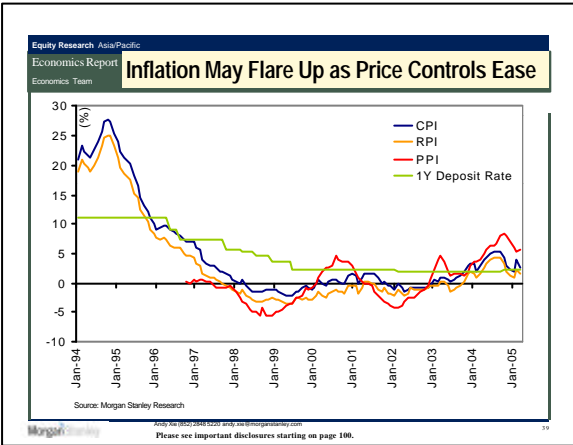
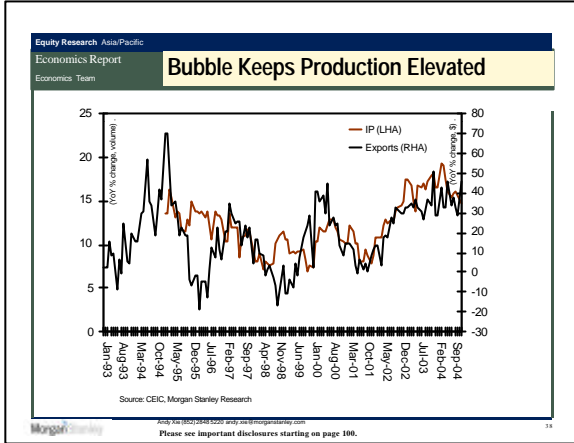
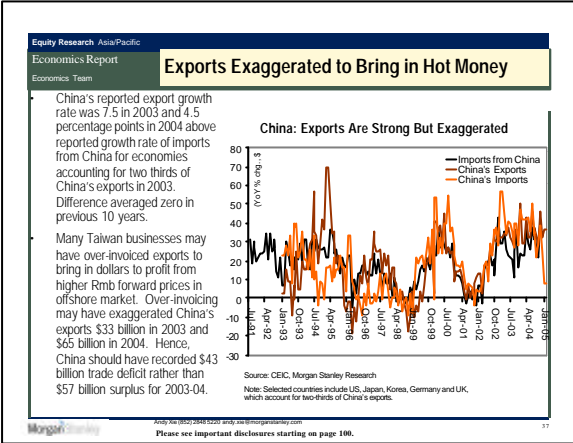
	1994-2002	2003	2004	1Q05
(YoY % change)				
Fixed Investment	12.4	26.7	25.8	22.8
Exports	13.2	34.6	35.3	34.8
Imports	12.4	39.8	36	12.2
Electricity	7.5	14.2	14.9	14.7
Property under construction	11.3	26.0	20.1	19.3
(YoY % change)				
Loans (Rmb trillion)		2.6	2.2	0.72
Forex Reserves (\$ bn)		162	207	49.2

Source: CEIC, Morgan Stanley Research

All cyclical indicators suggest that overheating has continued into 2005. As 1Q04 was the most overheated quarter, the mild slowdown in 1Q05 did not suggest a directional change at all.

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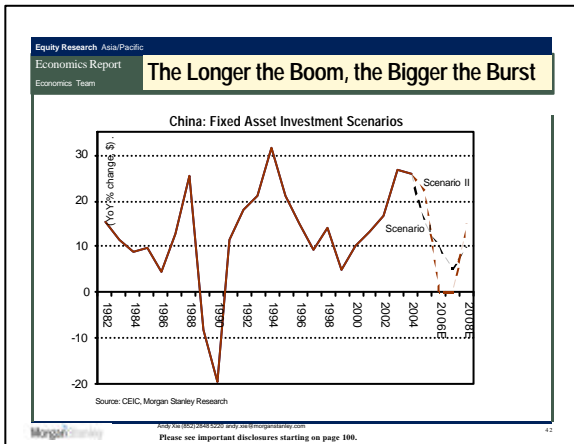
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2005 Scenarios

	Slow Fed	Aggressive Fed
China policy		
Status Quo	Bigger bubble	Deflating
Raise Interest Rate	Deflating	Popping
Ravalue	Popping	Popping
Appreciate slowly	Bigger bubble	Deflating

Source: Morgan Stanley Research

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Renminbi Peg: Where To?

May 2005

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Equilibrium in the Mundell-Fleming Model

$$Y = C(Y - T) + I(r^*) + G + NX(e)$$

$$M/P = L(r^*, Y)$$

The diagram shows a graph with the exchange rate (e) on the vertical axis and income (Y) on the horizontal axis. A downward-sloping IS* curve and a vertical LM* curve intersect at the equilibrium point. A horizontal dashed line from this intersection to the vertical axis is labeled 'Equilibrium exchange rate'. A vertical dashed line from the intersection to the horizontal axis is labeled 'Equilibrium level of income'.

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Equivalence of Fixed & Flexible Exchange Rate Systems

(a) The Equilibrium Exchange Rate is Greater Than the Fixed Exchange Rate. The graph shows a downward-sloping IS* curve and a vertical LM* curve. A horizontal line represents the fixed exchange rate, which is below the equilibrium exchange rate. The equilibrium output is Y1.

(b) The Equilibrium Exchange Rate is Less Than the Fixed Exchange Rate. The graph shows a downward-sloping IS* curve and a vertical LM* curve. A horizontal line represents the fixed exchange rate, which is above the equilibrium exchange rate. The equilibrium output is Y1.

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Monetary Policy Under Fixed Exchange Rates

Under floating rates, monetary policy is very effective at changing output.

Under fixed rates, monetary policy cannot be used to affect output.

The graph shows a downward-sloping IS* curve and a vertical LM* curve. A horizontal line represents the fixed exchange rate at e1. The equilibrium output is Y1. A shift in the LM curve to LM2 is shown, but it does not affect the equilibrium output Y1.

Results:
 $\Delta e = 0, \Delta Y = 0$

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Fiscal Policy Under Fixed Exchange Rates

Under floating rates, fiscal policy ineffective at changing output.

Under fixed rates, fiscal policy very effective at changing output.

The graph shows a downward-sloping IS* curve and a vertical LM* curve. A horizontal line represents the fixed exchange rate at e1. The equilibrium output is Y1. A shift in the IS* curve to IS1 is shown, which changes the equilibrium output to Y2.

Results:
 $\Delta e = 0, \Delta Y > 0$

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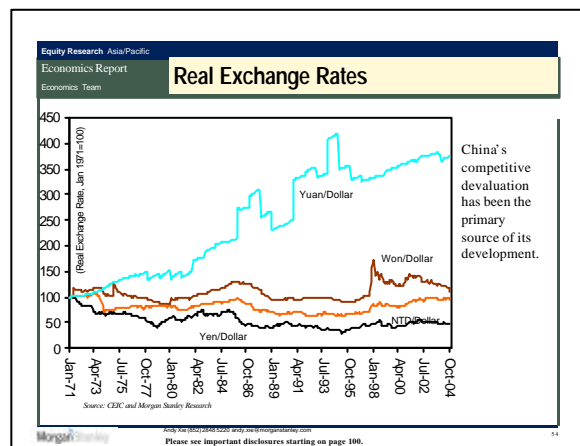
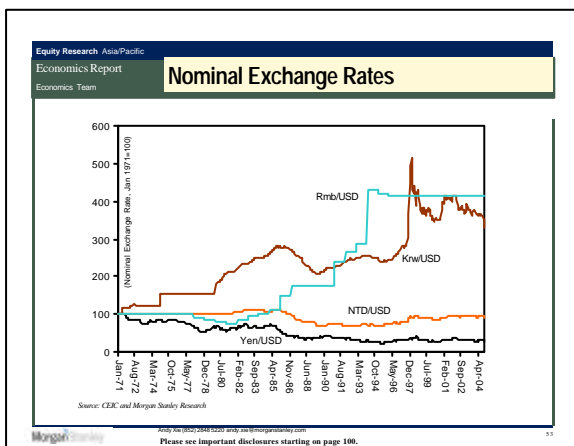
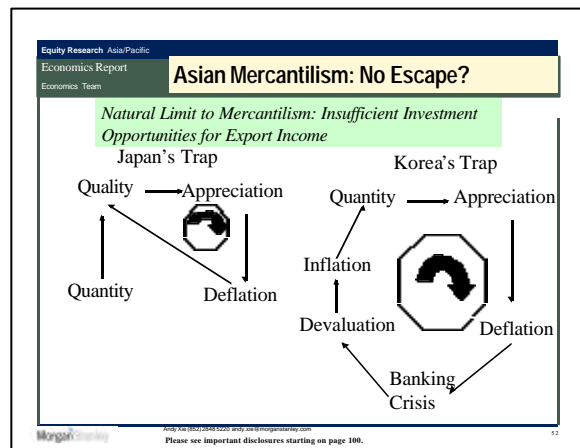
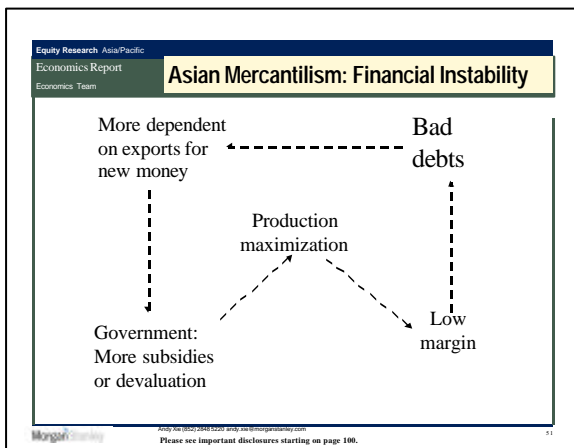
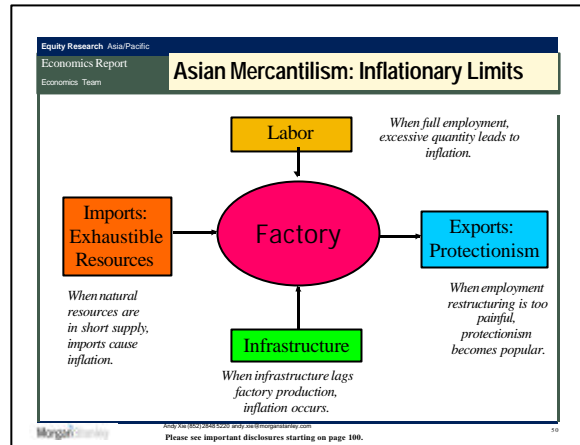
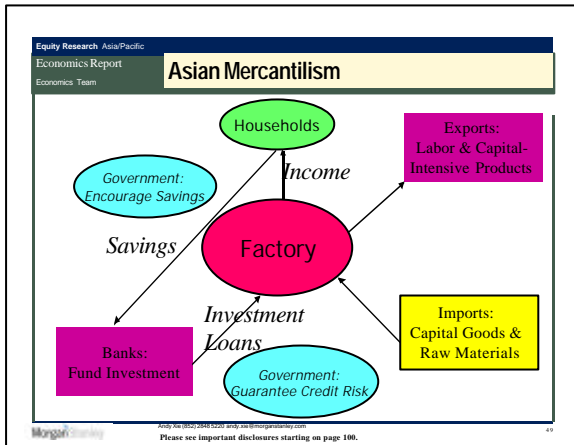
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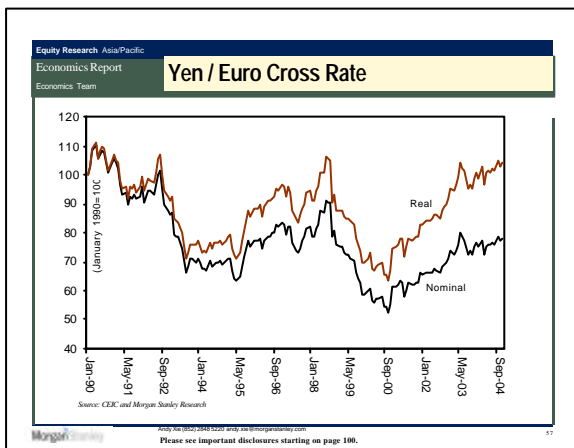
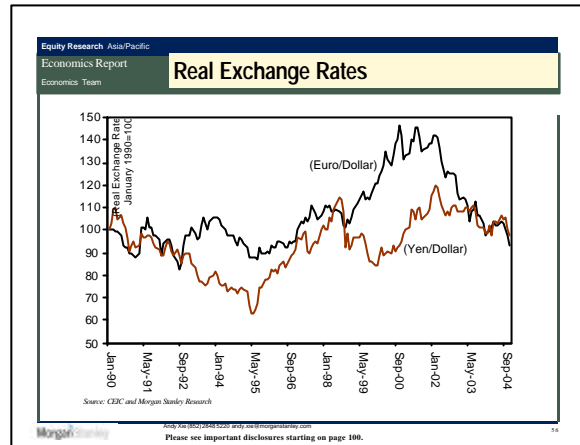
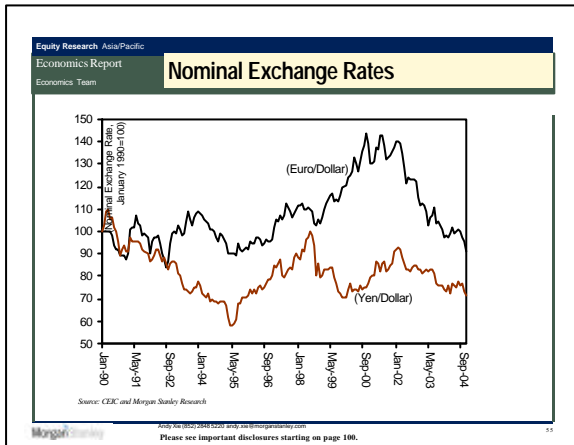
Mercantilism

Country A produces only consumption goods.
Country B produces only investment goods.
Country A wants more investment goods than the Ricardian equilibrium offers and keeps exchange rates lower.
The lower price of consumption goods entices Country B to give up more investment goods for consumption.
To sustain equilibrium, Country A must adopt a policy that artificially suppresses demand for consumption goods.

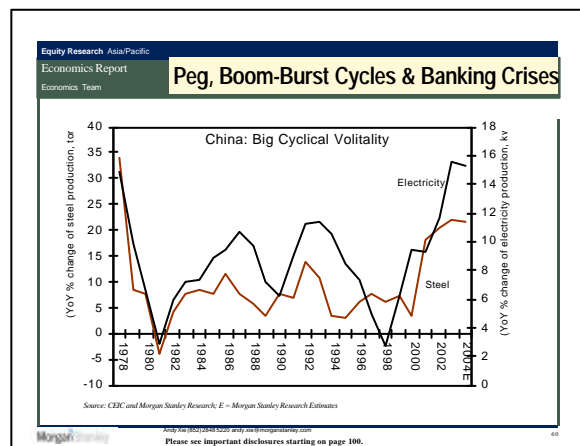
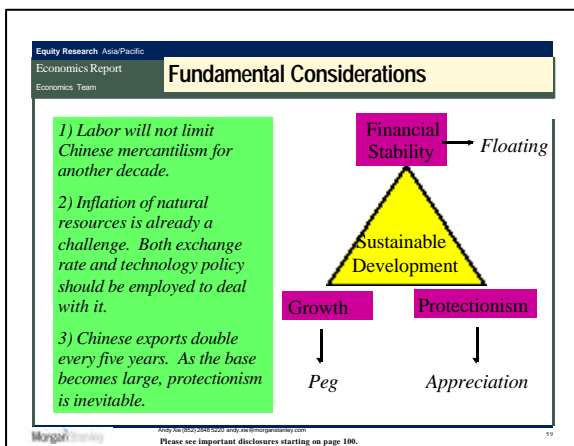
The diagram shows a graph with Consumption Goods on the vertical axis and Investment Goods on the horizontal axis. It illustrates Country A's Preference, Country B's Preference, Ricardian Equilibrium Exchange Rate, and Mercantilist Equilibrium Exchange Rate.

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- ### Exchange Regime Options
- **Peg:** Allows money supply fluctuations to absorb all the shocks and uses fiscal policy to smooth economic growth.
 - **Step Functions:** Shift peg periodically to reflect relative productivity trends to decrease money supply fluctuations.
 - **Basket Peg:** No one has tried. Some are implicit basket pegs, i.e., Singapore and Taiwan.
 - **Partial Float:** Accumulate or decrease foreign exchange reserves to smooth currency fluctuations.
 - **Float:** Zero foreign exchange reserves.
- Source: CEIC and Morgan Stanley Research
- Please see important disclosures starting on page 100.



Peg, Boom-Burst Cycles & Banking Crises

The combination of a peg and a government-owned banking system will almost surely lead to a banking crisis, in our view.

When the market becomes optimistic about a country, the currency will appreciate, if flexible, which makes optimism less affordable. A peg does not offer such a check.

When the banking system is owned by the government, there is no check against excessive optimism here either.

The combination causes fixed investment to surge during good times and crash when good times end.

The crash is then likely to leave behind a wave of bad debts. Government ownership prevents capital shortages from triggering a banking crisis.

There is likely to be a crisis when liquidity dries up, which occurs when exports experience a protracted downturn.

Flexible Exchange Rate and Panics

Chinese societies are prone to speculative manias and panics, in my view, and these can cause extreme volatility or even crises. Chinese economies tend to control exchange rates (e.g., Hong Kong, Indonesia, Malaysia, Singapore, Taiwan, or Thailand) to contain speculation.

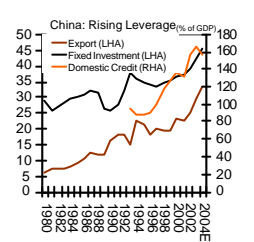
Excessive speculation and panics tend to develop in Chinese societies, similar to those in Europe and the US in the 18th and 19th centuries.

The Chinese have little trust in their own currencies as vehicles for value storage and favor the dollar. Their savings in local currencies were always inflated away in the past century. This low level of trust could turn a small shock into a crisis. Indonesia's crisis in 1997 was a good example. Chinese economies have eventually all ended with soft or hard dollar pegs.

Banking Reform Must Precede Currency Reform

After a decade of pegging the renminbi to the dollar, the Chinese economy has fully adjusted to it, e.g., the exports to GDP ratio has increased to 33% now from 15% in 1993. Domestic credit has risen to 165% from 96% over the same period. An abrupt change in the exchange rate would likely lead to a financial crisis, as a portion of economic activities supported by the excess credit creation becomes unviable.

Banking reform must (1) dig out loans that support unviable economic activities and (2) change future banking behavior.



Source: CEIC and Morgan Stanley.

Only Partial Float Is Consistent with China

The combination of large and adjustable forex reserves and a floating exchange rate is the only durable exchange rate model for Asian economies.

Asian economies with 'flexible exchange rates' adjust foreign exchange reserves to changing domestic monetary conditions. The underdevelopment of financial systems in Asia makes it difficult to control money supply via interest rates only. Instead, the currency impact on trade can change monetary conditions quickly.

China will not touch the exchange rate until the financial system is ready, in my view.

Hong Kong: The Liquidity Driven Economy

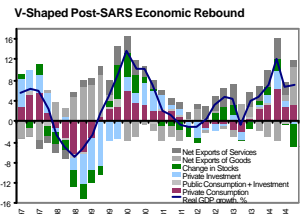
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May 2005

An Impressive V-Shaped Recovery

- The post-SARS V-shaped rebound is running out of steam as global demand cools, liquidity tightens, and the tourism boom runs into a high base.

- Real GDP is forecast to slow to 4.5% in 2005, from the impressive 8% in 2004. Nominal GDP returned to positive growth in 1Q04 for the first time since 2000. With 3.2% nominal GDP growth forecast for 2005, it will still be still lower than in 1997.



Source: CEIC, Morgan Stanley Research

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Hong Kong Exits Deflationary Cycle?

- Hong Kong's CPI inflation turned positive in July 2004, ending six years of deflation, which started after the 1997 financial crisis.
- Structural problems, namely price convergence with the mainland, may continue to keep inflation in check.
- The fixed exchange rate means that internal prices have to adjust to external shocks.
- Upside risk to inflation lies in further weakness in the US\$ and a revaluation in the Renminbi.

Source: CEIC, Morgan Stanley Research

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Revitalized Sentiment Boosts Consumption

- Pent-up demand after SARS and sentiment pickup pushed retail sales back to positive growth.
- Individual Visit Scheme (China relaxed citizens' travel to HK in 2003) led to a surge in tourists from the mainland.
- Impact of scheme is diminishing as repeat visits from low-income tourists are infrequent, while high-income groups have more options with relaxed travel restrictions to other destinations (e.g. Europe).

Average Wage and Deposit Per Person (US\$ (2003))	Annual Wage
China	1,691
Guangdong	2,422
Hong Kong	15,038

Source: CEIC, Morgan Stanley Research

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Yet, Job Quality Could be Declining

- The latest cyclical rebound eased overall unemployment rate from record high.
- Hong Kong is still clouded by structural unemployment. Strong cyclical growth in 2004 only brought about 0.9 percentage-point ease in the jobless rate, suggesting low employment elasticity, probably due to increasing integration with the Mainland economy and human capital pool.
- An increasing share of the working population is earning the lowest income.
- Even salaries of employers in the retail and service sector, which is benefiting directly from the consumption rebound and tourism boom, experience wage declines.

Source: CEIC, Morgan Stanley Research

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Liquidity Conditions Tied to Rmb Speculation

Associated with Speculation on Renminbi Revaluation

Source: Datastream, CEIC, Morgan Stanley Research

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Interest Rates on the Rise

Interest Rate Forecasts

Discussions	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
LIBOR 3M	1.00	2.00	1.11	0.18	4.00	5.00	3.89	3.78	4	4	4	4
HIBOR 3M	1.25	2.50	1.51	0.46	4.25	5.00	4.62	4.50	4.5	4.5	4.5	4.5
US Prime	2.25	3.25	2.16	0.35	5.25	5.00	4.24	3.63	4	4	4	4
US 10Y	3.75	4.25	3.12	1.23	5.25	5.00	4.60	4.30	4.5	4.5	4.5	4.5
US 20Y	4.25	4.75	3.59	1.31	6.25	6.00	4.40	4.40	4.5	4.5	4.5	4.5
US 30Y	4.50	5.00	4.28	1.38	7.00	7.00	5.00	5.13	5	5	5	5
US 10Y	4.25	4.75	4.00	1.40	7.25	7.25	5.30	5.43	5.5	5.5	5.5	5.5
US 20Y	4.50	5.00	4.00	1.40	7.50	7.50	5.45	5.58	5.5	5.5	5.5	5.5
US 30Y	4.50	5.00	4.00	1.40	7.50	7.50	5.45	5.58	5.5	5.5	5.5	5.5

Source: Datastream, IHMA, CEIC, Morgan Stanley Research

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Negative Real Rates? Unlikely

- Loose liquidity could keep interest rates at a low level in the short term. Real interest rates have plunged, giving support to asset prices.
- When liquidity conditions normalize, interest rates should rise faster than inflation.
- A return to the negative real rates seen in the mid-1990s is unlikely.

Source: CEIC, Morgan Stanley Research

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Rising Interest Rate Will Lower Property Price

- Real interest rate, not supply-demand balance, is the most powerful variable affecting the property price.
- Real interest rate will likely rise by four percentage points or more. Judging from historical correlation, property prices could decline by 20% or more in 12 months.
- In addition, high living cost relative to China keeps population from growing. Competition from Guangdong keeps wages down.

Interest Rate Will Reverse Property Market (YoY % chg.)

Source: CEIC, Morgan Stanley Research

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End of the Deficit Woes?

- F2004/05 turned out a surplus (HK\$21 bn, 1.6% of GDP) for the government, but the pleasing increase in revenue was again concentrated in non-recurrent sources: HK\$26 bn in debt issues, and HK\$20 bn in land sales.
- The operating balance before investment income from reserves remains in a structural deficit.
- Hong Kong still needs radical reforms to rebalance revenue between recurrent and capital sources.
- Premature complacency over improved budget balance and further postponing the introduction of broad-based taxes are potential bad news for the market.

Operating Deficit Hidden Behind Capital Surplus

Source: CEIC, Morgan Stanley Research

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Taiwan: Asset Market-led Recovery

May 2005

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Taiwan: Capex Outflow Has Ended

- Taiwan's capex outflow to China has ended. Equipment investment rose in 2004, for the first time since 2000. Taiwan has shifted as much production to China as it can for the time being.
- Investment in buildings has been rebounding sharply as confidence in property returns.

Source: CEIC, Morgan Stanley Research

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Taiwan: Money Returning

- As capex outflow stops, capital flow has turned positive. Forex reserves have been rising faster than the current account surplus because Taiwan businesses in China are repatriating profits.
- As money returns, Taiwan's money supply has staged strong recovery. While the growth rate has peaked, the loan growth rate should remain strong for another two years.

Source: CEIC, Morgan Stanley Research

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Taiwan: Property Market Is Recovering

- As capex outflow stops, labor market improves and confidence returns. Property market appears to have bottomed out and is staging a modest but likely sustained recovery.
- Shanghai prices (not real, manipulated by speculators) have risen above Taipei's, even though Taipei's disposable per capita income is 10 times Shanghai's. Some Taiwanese money is returning to Taipei from Shanghai for the first time.
- The DPP government appears to have stopped pushing independence for the next two years. This is a good environment for property to recover.

Source: CEIC, Morgan Stanley Research

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Taiwan: Rebound in Stock Market, Currency

- Capital returning and rebounding property market give support to both currency and stock markets. NT\$ is likely to be the strongest currency in Asia in 2005. NT\$/US\$ could drop below 30.
- Some of the returning capital is likely to go into the stock market. Domestic demand for financial assets in general should be positive.
- Financial consolidation is the key to moving Taiwan beyond the current stage and turn its market into another Australia. It is necessary to jump-start consumption.

Taiwan: EPS (YoY % change)

	2004	2005	2006	2007	2008	2009	2010
Total Mkt	46%	64%	82%	20%	8%	-6%	6%
Tech	96%	81%	127%	62%	73%	-19%	11%
Financial	2.8%	0.3%	0.2%	0.4%	0.97%	1.1%	1.2%
Plastics	-3%	-69%	na	na	133%	17%	13%
Telcom	8%	12%	8%	12%	2%	2%	2%
Transcra	16%	-89%	920%	7%	107%	-4%	-9%
China Pkg	-15%	8%	74%	36%	9%	0%	-15%

Source: CEIC, Morgan Stanley Research

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Taiwan: Interest Rate Still Needs to Rise

While the economy is losing momentum, the interest rate still needs to rise a bit, perhaps by 50 bps in 2005. Property speculation is beginning. The central bank should raise interest rates to prevent a bubble.

Source: CEIC, Morgan Stanley Research

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Taiwan: Population Outflow Weighs on Consumption

- Consumption is Taiwan's "Achilles' heel". Population outflow to Shanghai has caused consumption to decouple from consumer confidence or export income.
- Without strong consumption, Taiwan's economy is quite dependent on a property recovery and credit cycle upturn.
- If Taiwan cannot reverse the population flow, the asset market-led recovery will eventually falter. But, the recovery should last through 2006.

Source: CEIC, Morgan Stanley Research

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Taiwan: Deflationary Pressure from China

- Taiwan's manufacturing businesses are facing enormous pricing pressure from Chinese competitors, especially in downstream chemical, electronics and materials.
- Chinese prices bear little relationship to costs as local governments try to keep factories running with bank loans.
- Taiwan is about to embark on another wave of de-industrialization. The impact on the economy is uncertain at this point.
- Taiwan businesses dependent on Chinese domestic demand are facing similar pressure. Many Taiwan businesses may report big losses in China.

Source: CEIC, Morgan Stanley Research

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Korea: Still Cautious

May 2005

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Exports Losing Steam

- The external economic environment is turning harsh on Korea amid a policy-induced China slowdown and global liquidity tightening.
- DRAM prices point to deceleration in Korea's pillar IT exports. Handset demand is also easing.

Global Handset Demand

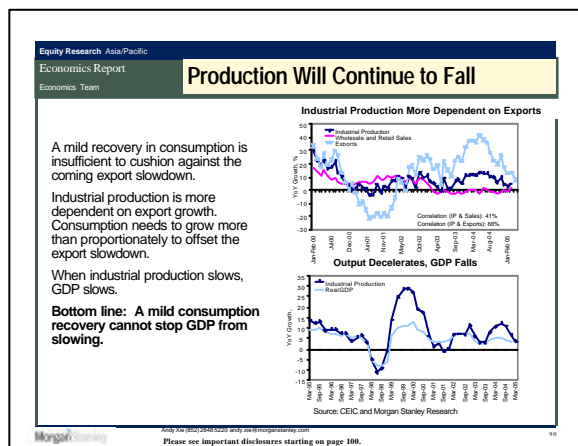
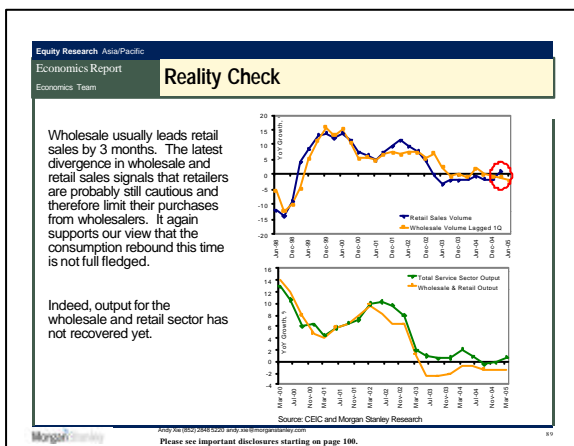
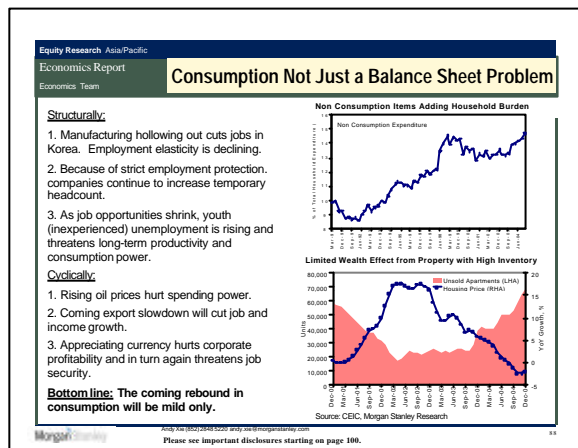
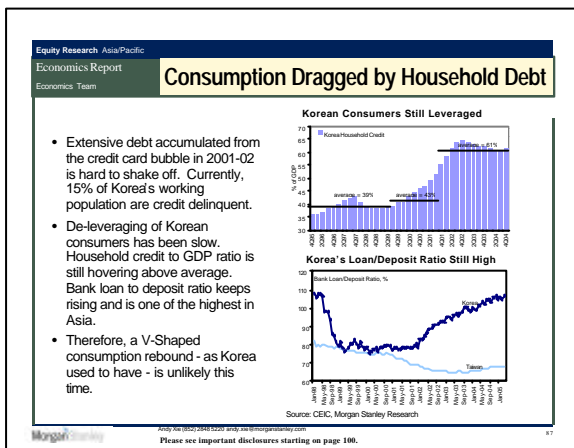
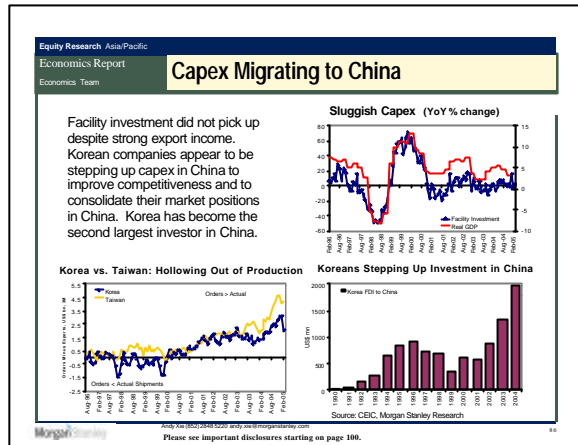
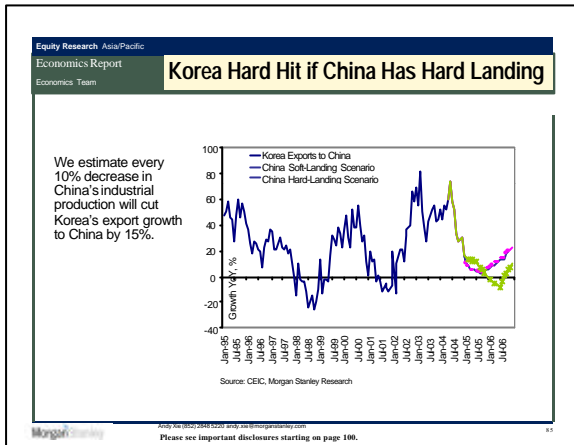
	2004	2005	2006	2007
YOY%	+21.7%	+26.0%	+4.1%	+3.8%

Source: Morgan Stanley Research

- A strong currency

Source: CEIC, Morgan Stanley Research

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Downside Risks Still Exist

Threats from a Strong Won:

- It will hurt corporate profitability and threaten employment. A difficult labor market will put pressure on an already fragile consumption recovery.
- It may cause SME debt problem to resurface as most SMEs do not hedge against exchange rate risk.
- It could cause Korea to fall into a trap of high current account surplus, strong currency but low growth and deflation.

An Appreciating Won Without Solid Economic Performance

Source: CEIC and Morgan Stanley Research

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The SME Problem

About one-fifth of Korea's manufacturing SMEs are running losses, with more than one-third failing to generate enough operating income to cover interest expense.

SME manufacturers are operating at below 70% of capacity compared with an average 80% of the overall manufacturing sector.

Most of SMEs are domestic-focused. The coming consumption rebound can help but the question is whether consumption can pick up rapidly and strongly enough before most SME debts mature this year and before reaching a situation where no more losses can be afforded.

Meanwhile, export-focused SMEs are threatened by a sharply appreciating won.

As the major employer, if the SME problem worsens, the labor market will be under significant pressure and will, in turn, hurt consumption again.

SME Output Lagging

SME - The Major Employer

Source: CEIC and Morgan Stanley Research

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Leading Indicators Signal Downturn

The Output-Inventory Cycle Indicates Only Beginning of a Downturn:

Stage 1 (Beginning of Downturn): Output Falls, Inventory Rises
Stage 2 (Approaching Bottom): Output and Inventory both Falls
Stage 3 (Recovery): Output Rises, Inventory Continues to Fall

Currently, Korea is still at Stage 1.

Output-Inventory Cycle

Liquidity Drying Up

Source: CEIC, Morgan Stanley Research

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GDP Drives Equity Market

Historically, KOSPI has never sustained any upward momentum when GDP slows. Is this time going to be different?

KOSPI and Economy Disconnects

KOSPI and Consumption Disconnects

Source: CEIC, Morgan Stanley Research

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Pump Priming Cannot Turn Around Weakness

- The one percentage point income tax cut will reduce taxpayers' bills by only 1% of GDP. Korea has fiscal room for more aggressive measures.
- The tax cut multiplier effect is going to be less than one because i) households are likely to use the extra money to repay debt, ii) non-consumption expenditure is taking up an increasing share of household expenses, and iii) households are also likely to save more in the face of economic uncertainty.
- Sales tax cut on big-ticket items appears misdirected.

Fiscal Balance, % of GDP

Net External Asset, US\$ bn

Source: CEIC, Morgan Stanley Research

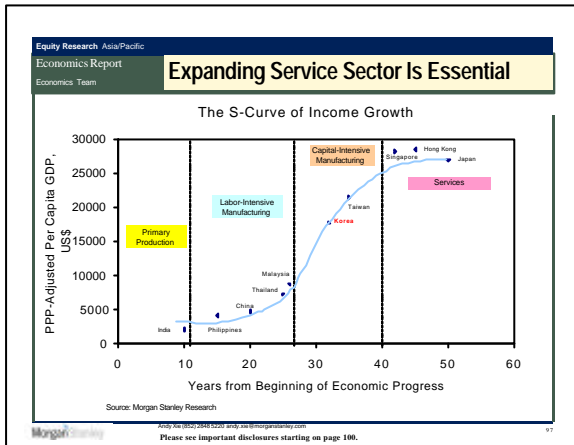
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What Korea Needs

- Short-Term Stimulus:**
 - A bigger income tax rate cut can be effective in three ways: i) help revive competitiveness, ii) boost sentiment and iii) increase spending power.
 - Continue frontloading of budget and more aggressive fiscal spending. More money should be spent on job creation. Capex should be lifted through infrastructure projects and facilities upgrade.
- Medium-Term Reforms:**
 - Modernize the labor market. Laws and institutions that meet international standards on handling labor relations should be established.
 - Improve corporate governance to get rid of "Korea Discount". Improve accounting and auditing practices to eliminate cross-shareholdings and strengthen transparency.
 - Encourage and subsidize R&D to find new sources of competitiveness and to move up the value chain.
 - Strengthen SMEs to reduce the country's dependence on chaebols.
 - Expand the service sector. To embrace globalization and competition, through which it can enhance the quality of its service sector.
 - Upgrade overall living standards. Secure interests of middle-income groups.

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	2002	2003	2004	2005E	2006E
Real GDP Growth (YoY %)					
NJA	6.1	6.5	7.4	6.6	5.7
China	8.3	9.3	9.5	9.5	7.0
India	4.7	7.3	7.2	6.6	6.7
Hong Kong	1.9	3.2	8.1	4.5	4.4
Taiwan	3.9	3.3	5.7	4.0	3.6
Korea	7.0	3.1	4.6	3.8	3.5
SE Asia	4.0	4.9	6.2	4.8	5.2
Indonesia	4.4	4.9	5.1	4.5	4.8
Malaysia	4.2	5.3	7.1	5.8	5.8
Philippines	3.1	4.7	6.1	4.0	4.7
Singapore	2.2	1.4	8.4	3.5	4.5
Thailand	5.3	6.9	6.1	5.7	6.0
CPI Inflation (% Period Average)					
NJA	1.5	2.1	3.5	3.4	2.8
China	-0.8	1.2	3.9	3.5	2.6
India	4.3	3.8	3.8	4.9	4.7
Hong Kong	-3.0	-2.6	-0.4	0.5	1.0
Taiwan	-0.2	-0.3	1.6	1.0	1.0
Korea	2.8	3.5	3.6	3.0	2.9
SE Asia	4.8	3.5	3.9	3.7	3.4
Indonesia	11.9	6.8	6.1	5.7	5.3
Malaysia	1.8	1.1	1.4	1.4	1.2
Philippines	2.9	3.0	5.5	5.9	4.8
Singapore	-0.4	0.5	1.7	1.4	1.1
Thailand	0.6	1.8	2.7	2.8	2.2

Source: Morgan Stanley Research. E = Morgan Stanley Research Estimates

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Equity Research Asia/Pacific Economics Report Asia/Pacific: Economic Forecast Summary (2)

	2002	2003	2004	2005E	2006E
Current Account (as % GDP)					
NJA	3.9	4.6	4.6	4.7	4.7
China	2.8	3.2	4.2	5.6	5.7
India	1.0	1.1	-0.2	-1.1	-1.0
Hong Kong	7.9	10.7	9.0	8.0	7.6
Taiwan	9.1	10.2	6.2	5.9	6.0
Korea	1.0	2.0	4.1	3.6	3.5
SE Asia	7.9	9.1	8.3	8.1	8.3
Indonesia	3.8	3.0	1.6	1.1	0.8
Malaysia	8.4	12.9	13.6	15.8	17.2
Philippines	1.0	4.2	5.4	4.4	4.2
Singapore	21.4	30.9	28.7	29.1	30.2
Thailand	6.0	5.6	4.0	2.5	2.7
Exchange Rate (Per US\$, Period End)					
China	8.28	8.28	8.28	7.80	7.50
India	48.0	45.6	45.0	42.0	44.5
Hong Kong	7.8	7.8	7.8	7.8	7.8
Taiwan	34.8	34.0	32.2	30.0	31.5
Korea	118.6	119.3	105.0	97.5	105.0
Indonesia	8940	8418	8900	8400	8800
Malaysia	3.8	3.8	3.8	3.0	3.2
Philippines	53.3	55.5	56.3	54.0	57.0
Singapore	1.74	1.70	1.64	1.58	1.62
Thailand	43.2	35.6	40.0	36.0	40.0

Source: Morgan Stanley Research. E = Morgan Stanley Research Estimates

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Global Rating	Count	% of Total	Count	% of Total
Overweight	105	35%	228	44%
Equal-weight/hold	82	28%	204	40%
Underweight/hold	57	19%	181	36%
Total	244	100%	513	100%

Overweight (O): The stock's total return is expected to exceed the total return of the relevant country MSCI index, on a risk-adjusted basis, over the next 12-18 months.

Equal-weight/hold (E): The stock's total return is expected to be in line with the total return of the relevant country MSCI index, on a risk-adjusted basis, over the next 12-18 months.

Underweight/hold (U): The stock's total return is expected to be below the total return of the relevant country MSCI index, on a risk-adjusted basis, over the next 12-18 months.

Buy (B): We consider that the stock has more than a 20% chance of price rise over the next 12 months, based on a quantitative assessment of historical data, or in the analyst's view, or based on more qualitative factors otherwise noted. We note that securities that we do not currently consider "buy" relative to, will perform in line with market.

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Hold (H): We consider that the stock has a 10% chance of price decline over the next 12 months, based on a quantitative assessment of historical data, or in the analyst's view, or based on more qualitative factors otherwise noted.

Sell (S): We consider that the stock has a 10% chance of price decline over the next 12 months, based on a quantitative assessment of historical data, or in the analyst's view, or based on more qualitative factors otherwise noted.

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