

QUARTERLY 2
G **GLOBAL** 0
OUTLOOK Q1 3



THE UNITED STATES	
A More Balanced Economic Recovery, Hopefully	3
ASIAN ECONOMIC OVERVIEW	
Adjusting To The Changing Global Environment	10
FX & INTEREST OUTLOOK	16
SINGAPORE	
Narrowly Avoided Double-Dip	17
MALAYSIA	
To Outperform Again In 2003	21
THAILAND	
Growth To Moderate Slightly In 2003	23
INDONESIA	
What Will Be The Fallout From The Bali Bomb Blasts?	28
PHILIPPINES	
Achilles' Heel Poses Risks To The Economy	31
TAIWAN	
Most Of Growth In Second Half	35
SOUTH KOREA	
Still Going Strong	38
HONG KONG	
Growth Likely To Be External-Led	42
CHINA	
Growth Engines Are Intact	46
JAPAN	
Some Sort Of Strategy To Tackle Structural Woes At Last?	50
AUSTRALIA	
A Display Of Strength	56
EUROZONE	
EUR Benefiting By Default	60
UNITED KINGDOM	
Steady As She Goes	63

QUARTERLY TECHNICAL STRATEGY

UOB INDICES

Jimmy Koh Chew Teck
Head of Treasury Research
(65) 6539 3545
Jimmy.KohCT@uobgroup.com

Diane Ho Ching Ching, CFA
Treasury Economist
(65) 6538 2169
Diane.HoCC@uobgroup.com

Loh Mei Ling
Treasury Research Analyst
(65) 6539 3549
Loh.MeiLing@uobgroup.com

Teo Bee Ling
Economist
(65) 6539 3923
Teo.BeeLing@uobgroup.com

Low Ping Yee
Economist
(65) 6539 3922
Low.PingYee@uobgroup.com

Tan Lena
Research Assistant
(65) 6539 3926
Tan.Lena@uobgroup.com

**QUARTERLY
TECHNICAL STRATEGY**
prepared by
Quek Ser Leang
Director, FX Proprietary Trading
(65) 6539 2997
Quek.SerLeang@UOBgroup.com

Information as of 02 January 2003



UNITED STATES

As we head into 2003, the patchy recovery in the US economy appears to be skating into thin ice again after seemingly emerging from its soft spot in early Q4 2002, beset by confidence-sapping and risk aversion-inducing geopolitical concerns and risks of a debilitating rise in oil prices. Yet beyond the immediate theme of geopolitical tensions and risk aversion, year 2003 promises to be one of several themes, one of which is reflation efforts for the US economy spurred by US policymakers' determination to secure a more firmly grounded economic recovery. We have already witnessed the Fed having no qualms in cutting interest rates by another 50bps to take Fed fund rates to a low of 1.25% in November 2002 in reaction to downside risks as the US economy waded through a soft patch even though an incipient rebound in the stock markets by late October appeared to signal that the US economy could probably make it through. US President Bush has also changed two key members of his economics team, bringing in a new Treasury Secretary and presidential economic adviser to signal a stronger and more coherent move towards fiscal stimulus. The other theme for 2003 is a continued correction of the still over-valued USD, abetted by underlying concerns of the return of the twin deficits (current account and budget deficits). The USD, though, would probably enjoy a temporary rebound in Q2 assuming a benign war scenario (current market consensus) which is expected to lead to an abatement of risk aversion. The USD could draw greater comfort if the end of an expected short war in the Middle East is also accompanied by a sharp rebound in the US stock markets and corporate bonds (narrowing credit spreads). However, should the war go badly and geopolitical tensions heightened further and exacerbate risk aversion, the USD is likely to suffer a sharper depreciation as global capital seek safe havens and exhibit greater home bias.

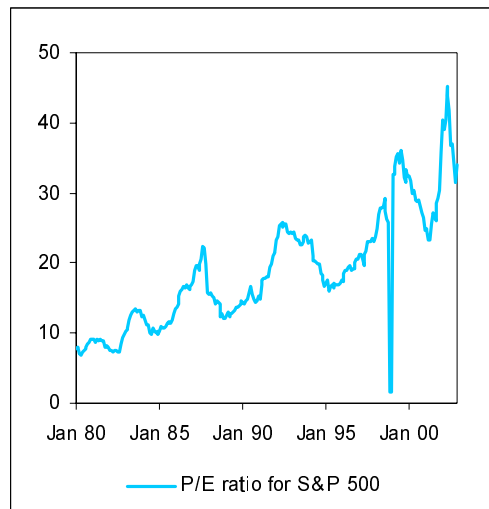
Our central scenario for the US economy is still one of gradual recovery, hopefully on more secure footing, albeit still below trend. The economic recovery process should be underpinned by fiscal and monetary policy traction and a pick-up in business spending, underpinned by replacement demand which is already evident. We have also adopted the assumption a benign war scenario that is the current market consensus, being no geopolitical and military experts. While we expect US consumer spending to slow along with an expected slowdown in mortgage refinancing activity and only a gradual pick-up in jobs, we, nevertheless, build in a respectable consumer spending rate in the high 2+%. We expect the alleviation of geopolitical risks and hopefully a more robust equity market after 3 straight years of decline and the anticipation of tax cuts to provide support for consumer confidence and spending. (Admittedly, equity valuations as measured by P/E ratios appear to remain rich.) We expect the US GDP growth to edge up to 2.7% in 2003 from an estimated 2.4% in 2002. In this environment, we expect the Fed to remain on extended hold, keeping Fed fund rates at 1.25% and only moving to gradually 'normalise' rates, starting sometime in Q3. The current benign inflation environment allows it leeway to adopt an extended wait-and-see stance.

Risks to our central scenario appear to be skewed to the downside. For one, if the war progresses less smoothly than currently expected, oil prices could see sustained sharp spikes beyond USD 40 per barrel, which would cut deeper into consumers' disposable incomes and lower spending on other goods. Sustained rises in oil prices would also act as a drag on corporate profits which would have negative repercussions for the anticipated pick-up in capital spending, exacerbated by expectations of lower final demand. Other than being a weight on confidence, a prolonged war would also worsen US budget position, whereby a significant deterioration could threaten to send long-end yields higher, notwithstanding safe haven demand. Another risk to the central scenario of a gradual US economic recovery stems from greater than expected retrenchment by the US



consumer amid stepped up efforts to repair their balance sheets and savings ratio, egged on perhaps by slow improvement in job conditions, declining household net worth and/or sliding confidence on any prolonged geopolitical tensions. A USD crash, which in turn triggers a vicious cycle of capital flight from the US, sending yields higher and stock prices plunging would be another risk for the US economy. However, at the present moment, we attach a small probability to this outcome in view of the lack of appealing alternatives with both Eurozone and Japan economies suffering from structural woes of their own. That said, financial markets are volatile to say the least and extreme fear/risk aversion could potentially lead to destabilizing capital flows. The sole upside we have been able to identify is if the looming war in the Middle East were to progress swimming well and inject a burst of exuberance and confidence in the financial markets, general public and businesses. The ensuing plunge in oil prices following a successful resolution to geopolitical tension would also provide some relief for households' disposable incomes and corporate margins.

P/E ratios remain above long-term average



Source: CEIC

Bracing for War...

The most frequently mentioned date for an attack is February with a final decision on war likely to be made after the 27 January deadline when UN weapons inspectors submit a report about Iraqi compliance with UN Security Council resolutions. According to the Center for Strategic and International Studies¹, a 40-60% probability is attached to a benign war scenario, 30-40% probability attached to an intermediate war scenario and 5-10% probability attached to the worst case scenario.

Under the benign war scenario, the most likely outcome is envisioned to be a quick and decisive victory within four to six weeks with no meaningful use of weapons of mass destruction (WMD), no major disruption to oil supplies in the region and limited fallout on friendly Middle Eastern

governments. Under this scenario, there is likely to be only a short-lived spike in oil prices and limited budgetary and economic impact for the US economy. It is this scenario that has been largely discounted by financial markets at the current juncture.

In the intermediate case, fighting could take place for 6-12 weeks with greater collateral damage/negative press, greater disruption to oil supplies and some political instability in the region. In this case, we expect oil prices to sustain their spikes for a longer period of time and there would be a greater decline in stock prices and confidence, heightening downside risks to the US economy.

In the worst case scenario, fighting would be protracted (90-180days). There could be major casualties suffered by US and UK forces, an attendant rise in anti-war movements, significant damage to oil supplies in the region and massive political unrest in the Middle East region. In this scenario, oil prices risk spiking to USD 80-100 per barrel (today's equivalent of prices during the 1970s oil shock) and staying above current USD 30 per barrel for an extended period of time through 2003. In this scenario, stock prices and confidence would plunge, sending the global economy decisively into a recession. The USD is also likely to suffer a sharper depreciation on increasing risk aversion. Long end yields could perhaps edge higher on higher risk premia on concerns of sustained fiscal deficits resulting from a prolonged war and planned fiscal stimulus.

If either the Intermediate or Worst case scenario for the war materializes, we expect the Fed to cut

¹ After an Attack on Iraq: The Economic Consequences Conference Summary, Center for Strategic and International Studies, November 21, 2002



Fed fund rates further to close to the zero bound and if necessary, employ some of the other monetary easing methods which Fed governor Bernanke had carefully detailed in a recent speech.² This includes committing to a specified period of zero interest rates to help push long-term rates lower, announcing and targeting specific ceilings longer-term Treasury yields, accommodating fiscal expansion by open market operations (ie monetizing fiscal stimulus) and subsidizing bank lending. In the current low inflation environment where global deflation fears are never far from the background given excess US capacity and little growth momentum, the Fed is likely to be more concerned about the negative implications for US economic growth from a sustained rise in oil prices and sharp drop in confidence rather than the inflationary aspects of oil price spikes. In any case, flexible labour markets, little growth momentum and spare capacity is likely to ensure that any rise in headline inflation from oil spikes would be temporary.

Beyond the war...reflation, reflation, reflation

Both fiscal and monetary policy are geared towards reflating the US economy in 2003, at least ensuring that a gradual recovery of the US economy can take place on firmer grounds rather than being fraught with downside risks as it had been in the past year. Even by remaining on extended hold on interest rates, the Fed has already forced short-term interest rates to well below equilibrium levels, which invokes a powerful incentive for investors to move out from low-yielding money market instruments and seek higher yields as soon as risk aversion abates a tad. Thus, the Fed's accommodative policy stance provides ongoing relief as long as short-term interest rates remain below neutral levels (estimated 4.5%-5.0%). Were downside risks to growth heighten again (arising from, say, US stock markets continuing on their downtrend for a rare fourth straight year³), we do not rule out further easing by the Fed. The Fed has already signalled clearly that it had learnt from Japan's deflationary experience and is keen to prevent risks of deflation from intensifying. The Fed is only likely to start to 'normalise' rates (ie hiking interest rates gradually to neutral levels) only when it is reasonably sure that the US economy is back on a sustainable growth path with payrolls and business capital spending showing decent gains.

Benign inflation picture provides leeway for Fed



Source: CEIC

On the fiscal front, the Bush administration has already planned new fiscal measures which are expected to be detailed in January by the new Treasury Secretary and economic advisor who have been brought in just to 'sell' the package to the Congress, businesses and public. With US President Bush having led the Republicans to a victory at the November 2002 mid-term elections, securing control of both the House of Representatives and Senate, his administration now has no convenient scapegoats to blame should the economy fail to recover in time for the November 2004 presidential elections. Thus, in terms of economic policies, the focus for the Bush administration is on reflating the US economy, with President Bush probably having learnt well the lessons of the presidential re-election defeat for his father in 1992, despite the Gulf War victory. Details of the latest stimulus package are yet to be available though it is widely expected that the Bush administration will push through fiscal stimulus worth about USD 50-75bn

for 2003. Measures under consideration include frontloading from 2004 personal income tax cuts

² Deflation: Making sure "it" doesn't happen here, Fed Governor Ben S. Bernanke, November 21, 2002

³ The Dow and S&P 500 had fallen for four straight years only once since they were created, during the period between 1929 - 1932.



incorporated in the tax cut agreement in 2001, extending unemployment benefits, further accelerating depreciation of business investment, cutting payroll tax, expanding capital loss write-offs, and reducing/eliminating the double taxation of dividends. (Note, though, that the 10-year budget impact of the expected fiscal stimulus amounts to about USD 300bn, smaller than the USD1.35tn package that was enacted in 2001. Also, federal fiscal stimulus is expected to be partially offset by belt-tightening at the state and local levels which is expected to total about USD 20-30bn in spending cuts and tax increases in order to comply with balanced budget requirements.) The fiscal stimulus package is only likely to be passed by May at the earliest with its impact felt most perhaps after the economy has begun to firm. Nevertheless, the Bush administration is unlikely to be deterred and is likely to step on the fiscal gas pedals in an attempt to get the economy in a fine growth form by November 2004.

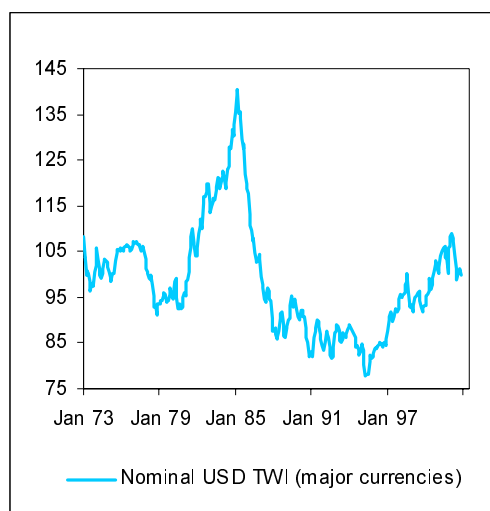
Twin deficits to return to haunt the USD...

The USD TWI (nominal major currencies) has depreciated by some 8.47% from 2 January 2002 levels by 24 December 2002. While the slide in the USD TWI had been triggered first by a loss of confidence in US equities as accounting scandals took hold, signs that the current account is increasingly under-financed put the USD on a weak footing on a fundamental basis. There appears to be persistent deficit in the US basic balance of payments (ie current account + FDI + net portfolio inflows), largely due to a shortfall in FDI for 5 consecutive quarters. (In the latest data, basic BoP deficit amounted to an annualized USD 156bn in the latest quarter from a deficit of USD 53bn in 2001.) Thus, we expect the USD TWI (nominal major currencies) to depreciate by another 8% or so in 2003, pressured by the twin deficits of current account and budget, particularly with the USD TWI still widely estimated to be over-valued by some 15% or so. Barring a sharp loss of confidence in the US, we do not expect the USD to crash as there remains no credible alternatives with both the economies of Eurozone and Japan facing structural woes and Asian central banks still content to accumulate USD reserves.

With current account deficit expected to hold steady around 5% in 2003 and budget deficit to widen to about 2.5% in 2003 from 1.5% in 2002 (assuming modest fiscal stimulus and a short war), the twin deficits when taken together are likely to raise concerns and keep the USD on the defensive. This is even as the budget deficit itself is of little concern yet in view of relatively low budget deficit to GDP ratio and debt-to-GDP ratio. For a historical comparison, back in 1986 when the US twin deficits were the main concern of global policymakers, the US federal budget deficit was around 5% to GDP and current account deficit was around 3.3% to GDP. At 5%, the current account deficit has reached levels that are widely considered to be unsustainable, at a time when short-end interest rates in the US have been reduced so low as to make the USD a funding

currency. Moreover, capital inflows are increasingly going to fund consumer spending and government debt rather than investment as during the 1990s boom years, which adds further doubts to the sustainability of the current account deficit.

Reversal in broad USD to continue



Source: Federal Reserve

Faced with risks about a disorderly decline in the USD in view of the twin deficits, we do not expect the newly appointed US Treasury Secretary explicitly and formally shift to a weak USD policy from the current strong USD policy. Doing so would risk fuelling a crash in the USD and expectations of a sharp decline in the USD in turn risk a vicious cycle of capital flight (rising yields, falling stock prices) and ever weakening USD with negative repercussions for the real economy. The Bush administration would probably be happy to see the USD drifting lower

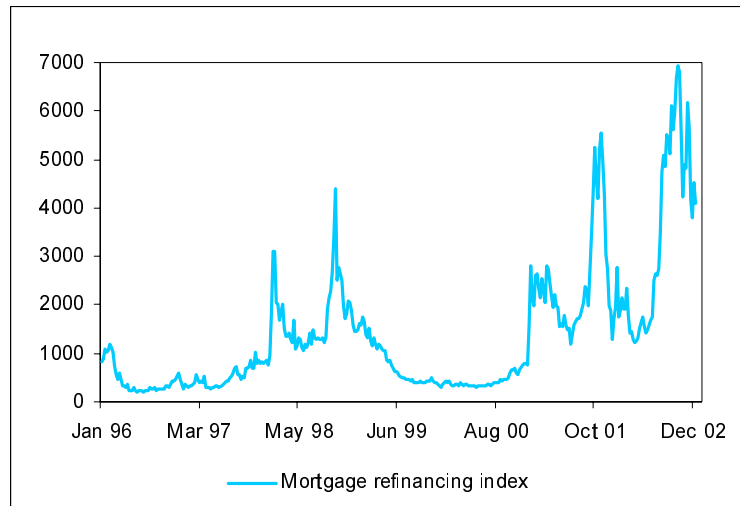


in a gradual manner, led by the markets, adding a little more stimulus to a soft US economy. This means the new Treasury Secretary is likely to only pay lip service to the USD policy when necessary, saying that the USD policy remains intact without going into the specifics of what the USD policy entails. Essentially, the de-facto USD policy is likely to be one of 'benign neglect' as long as the slide in the USD does not become too disorderly.

Downside risks to real economy to keep a close eye on...

Sharper-than expected consumer spending slowdown. Our central scenario is for a still respectable high 2+% rate of consumer spending for 2003, albeit paling in comparison to an estimated 4% growth for 2002. However, amidst anecdotal reports of a lacklustre Christmas shopping season, risks that consumers would retrench more than expected remain real. This is even as consumers showed a remarkable bounce back in spending in October and November following a soft patch despite weak jobs growth and consumer confidence levels over the period. While mortgage refinancing activity doubtless played a part in augmenting consumers' disposable income and spending, barring a sharp fall in long-end yields towards 3%, the likelihood of another round of mortgage refinancing windfall is unlikely. If equity markets continue to slide for some reason even after the resolution of Middle East geopolitical tensions, the threat that consumers would start to repair balance sheets and rebuild savings rate is non-negligible. Other than an unexpected plunge in equities, a plateau or retreat in house prices could also compel consumers to start saving more. As it is, household net worth fell sharply in Q3 2002 (latest available data from the Fed), which has dragged the ratio of net worth to disposable income to its lowest level since Q2 1995. Moreover, personal savings rate remain historically low still which is not likely to be sustainable in face of the decline in the ratio of household net worth to disposable and expected returns from financial assets.

Mortgage refinancing activity tapering off



Source: Bloomberg

Disappointing pick-up in business spending. Recent growth in business spending on high-tech equipment and software, underpinned by replacement demand has stoked hopes that the long awaited business capital spending recovery has begun. However, business spending on other types of equipment and facilities, accounting for the other two-thirds of business capital spending, remains lacklustre. While our central scenario anticipate a gradual pick-up in capital

spending on the back of replacement demand as the US final demand firms, still low capacity utilisation rates signalling spare capacity argues against a robust recovery in traditional business capital spending – unless there is a sharp upwards shift in expectations of return on capital for some reason. We are also wary of a stalling in the improvement corporate profits recovery, which no longer has a flattering low base to fall back on, would dampen capital spending even as low interest rates and tax breaks provide cushion. Unfunded pension liabilities of some big corporations could also sap corporate profits.⁴ If US businesses remain less than confident about prospects of

⁴ According to Watson Wyatt study, only about 40% of pension plans had assets in excess of plan liabilities as of January 1, 2002, down from about 85% in 2000. Prolonged equity weakness could see only about one-fifth of corporate pension plans having sufficient funds to fully cover liabilities in 2003. If a pension plan's valuation assets to current liability ratio falls below 0.9, the plan may be subjected to additional minimum funding requirements above and beyond normal funding requirements.

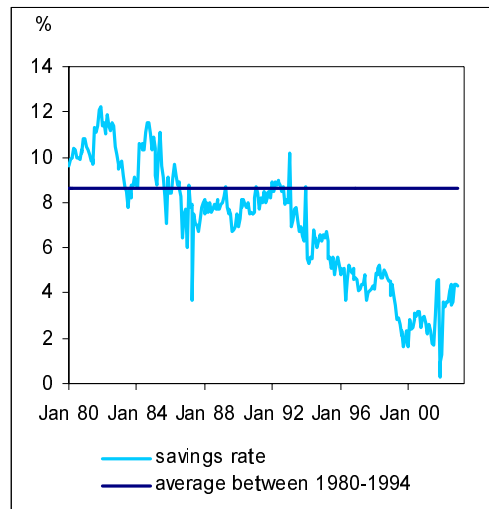


Households' Net Worth declines (USD bn, not seasonally-adjusted)

	Real Estate	Financial Assets	Net worth	Households' net worth as a % of disposable personal income
1995	7,991.6	21,620.9	27,581.7	508.7
1996	8,318.7	24,049.6	30,096.3	530.1
1997	8,782.5	27,537.7	33,855.1	567.3
1998	9,526.0	30,547.6	37,346.3	587.6
1999	10,412.1	35,081.8	42,371.6	639.3
2000	11,479.2	33,910.8	41,960.0	589.3
2001	12,578.6	32,379.8	41,071.2	555.5
Q12001	11,822.3	32,033.3	40,459.0	552.9
Q22001	12,128.8	32,883.9	41,449.5	564.7
Q32001	12,424.5	30,864.6	39,503.8	525.0
Q42001	12,578.6	32,379.8	41,071.2	555.7
Q12002	12,869.6	32,564.3	41,469.9	540.8
Q22002	13,233.5	30,980.6	40,126.1	515.3
Q32002	13,414.3	29,110.6	38,315.1	486.4

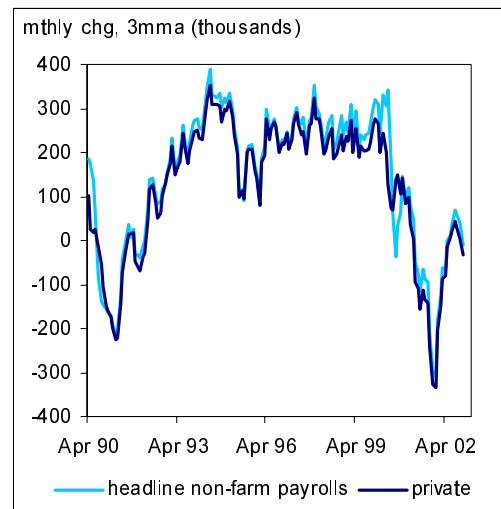
Abridged from Federal Reserve's Flow of Funds

Savings rate remain below long-term average

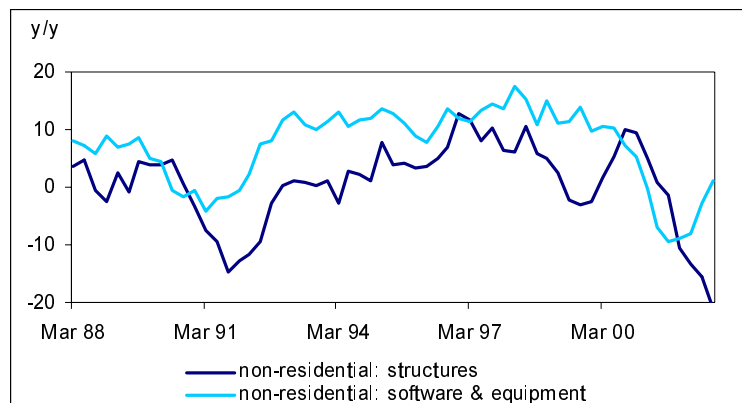


Source: CEIC

Payrolls show renewed signs of weakness



Business capex supported by replacement demand

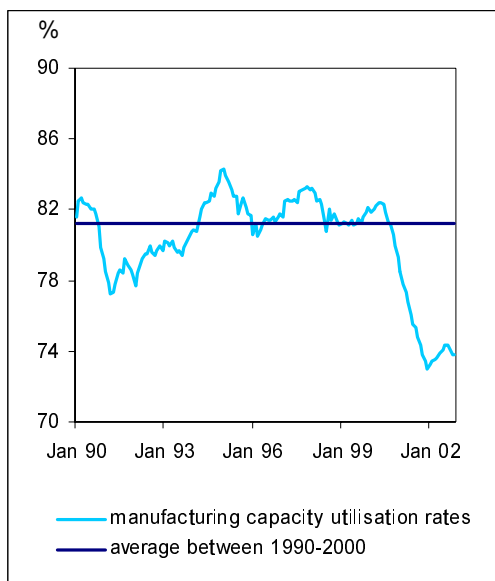


Source: CEIC

a sustained improvement in final demand (of which consumers account for 70%), then there is little reason to boost investment in face of spare capacity still. Thus, consumer spending along with consumer confidence levels and the direction of the equity market could provide the most timely indications of the likely path of business capital spending.

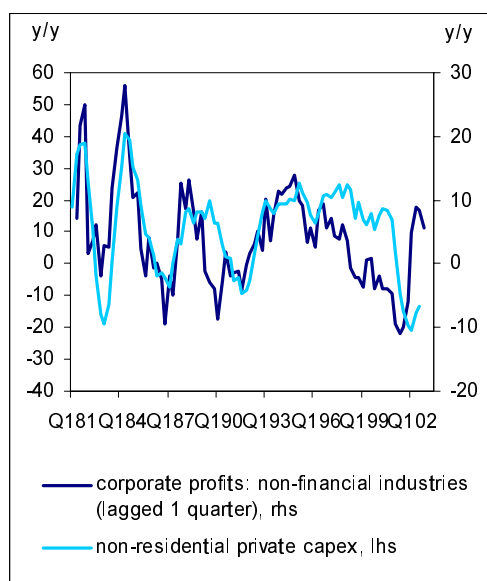


Capacity utilisation rates remain low



Source: Bloomberg

Stalling corporate profits would suggest modest capex recovery at best

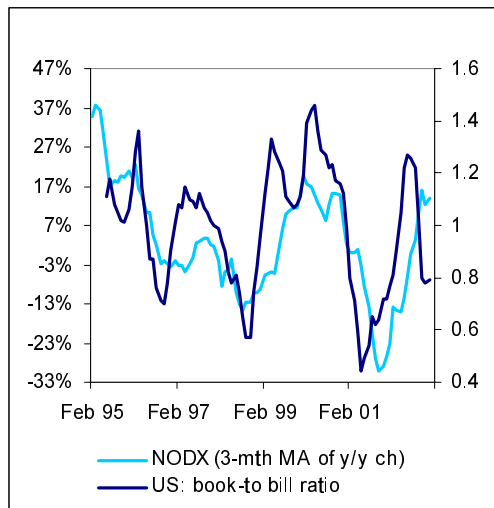


Source: CEIC

ASIAN ECONOMIC OUTLOOK

For 2002, it was indeed a year of surprises. The much anticipated interest rate hikes in the US failed to materialize as uncertain global environment continues to weigh on the investment led recession. In fact, against expectation of at least 175bps rate hikes before the year-end, US closed the year with its Fed funds rate 50bps lower at 1.25%. Recovery in global tech demand also disappoints, with global semi con sales expected to end the year around flat vs earlier expectation of 20+% growth.

Global electronics demand running out of steam

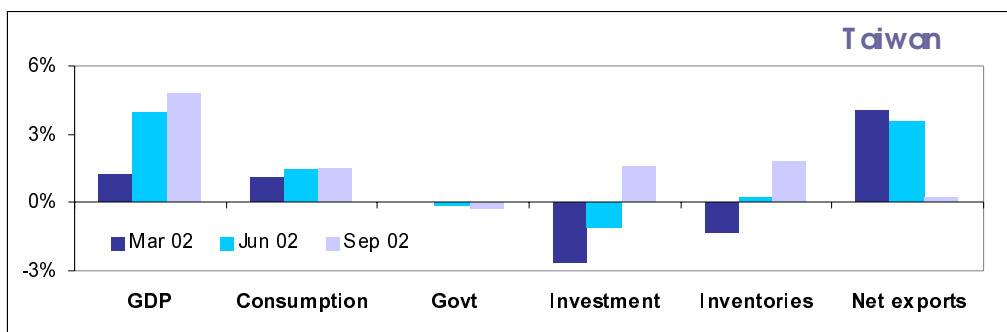


Source: CEIC

As global demand flatters, Asian economies that have turned to domestic engines have shown some impressive results. Against projection of 3.5% at the start of the year, Thailand is now expected to post growth of close to 5% in 2002. Korea is expected to register 6% growth vs expectation of 5% in Mar 2002. Malaysia and the Philippines are expected to end the year with 4% growth, while Indonesia at 3.3%. Repercussion effects of the Oct 12 Bali blast are likely to have bigger impact on 2003 growth, with the govt having to revise down its projection by 1% point to 4%. Global downturn and the rise of China have badly battered the NIEs. With per capital income at more than \$20,000p.a, cost conscious companies are now turning to China. Although Taiwan is expected to clock growth of 3% last year, it is largely the result of basis effect from the contraction of 1.9% in 2001. HK remains in the doldrums, although spillover from China

is benefiting the SAR somewhat. Reportedly, there is increasing congestion at Shenzhen's ports, which have resulted in some business flowing back to HK. The SAR is also benefiting from the influx of Chinese tourists. Hollowing effect and the global downturn threatened to push Singapore into its 2nd recession in 2 years, although the advance estimate figure managed to push the republic's economy into the black (up s/adj 0.1%q/q).

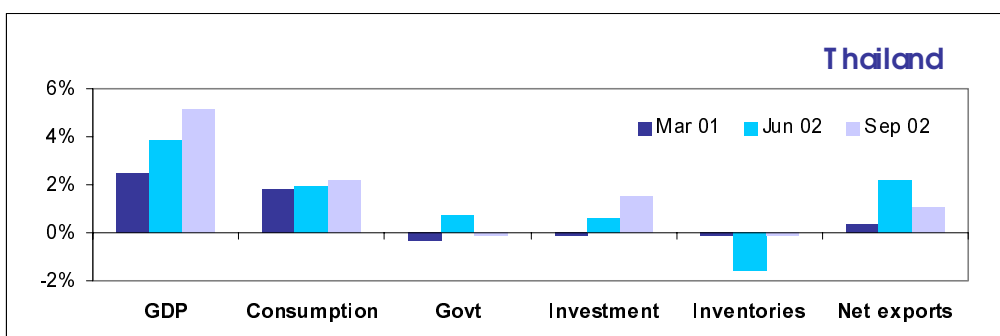
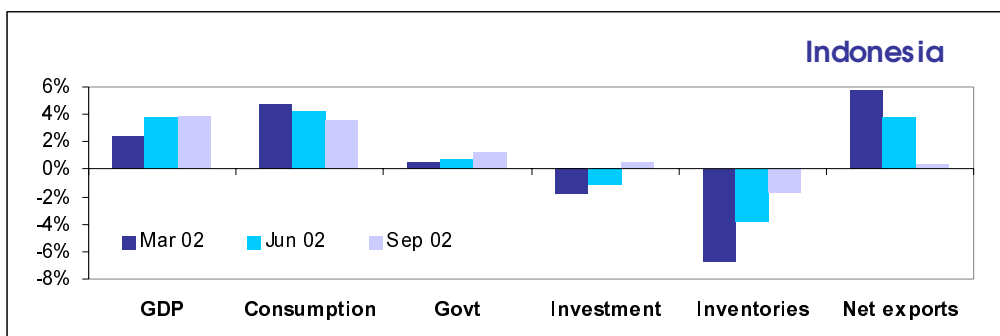
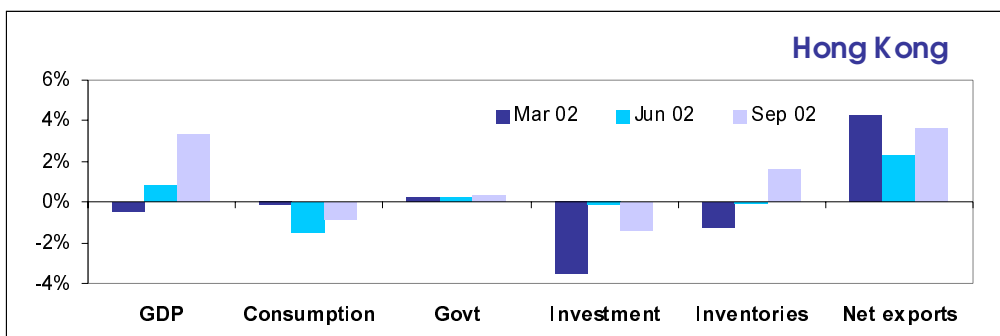
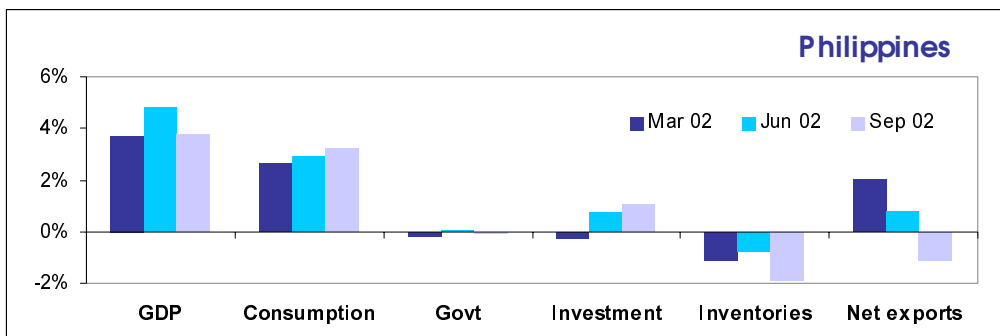
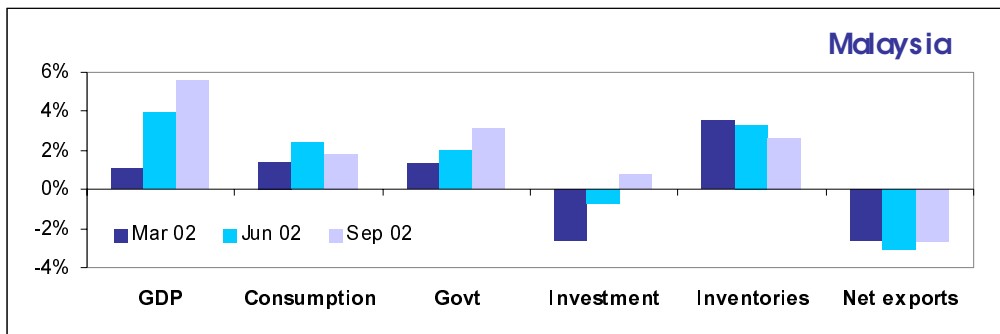
GDP Contributions



Source: CEIC



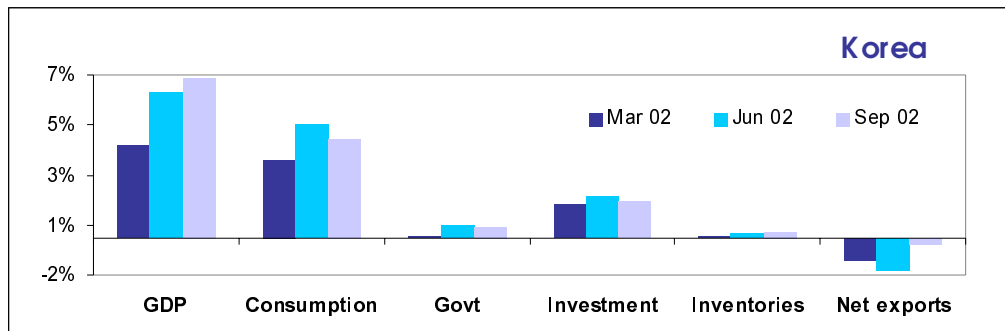
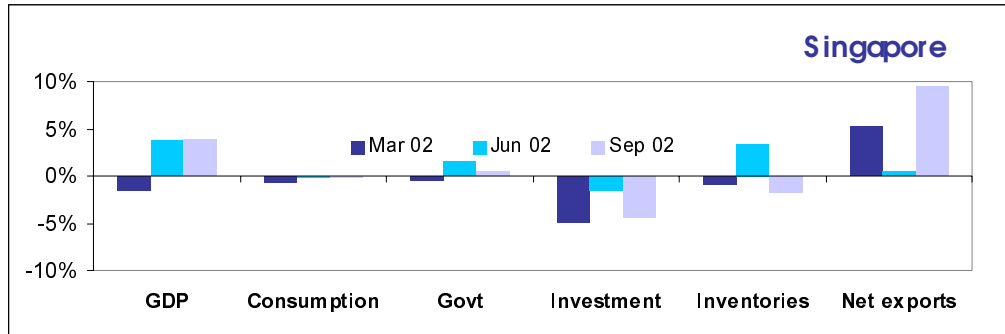
GDP Contributions



Source: CEIC

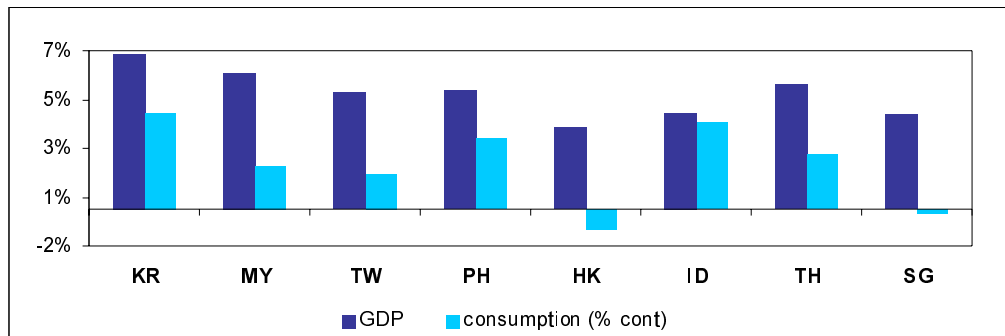


GDP Contributions



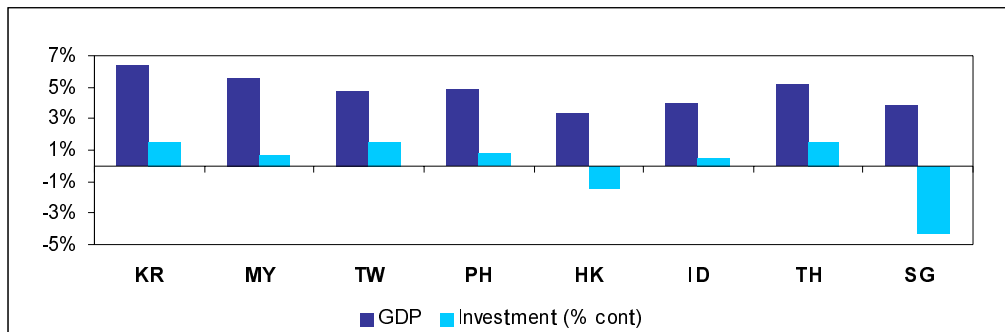
Source: CEIC

Consumption lack life in NIEs (Q302)



Source: CEIC

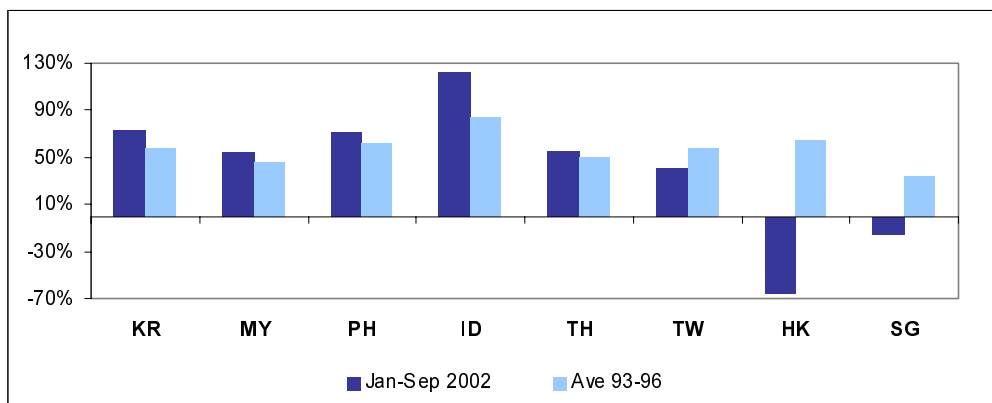
Excess capacity remains an issue (Q302)



Source: CEIC



Consumption contribution to GDP



Source: CEIC

Outlook in 2003: Moderation in all engines

Asia has been trying to source for alternative engines to compensate the increasing global volatilities. Korea, Thailand and Malaysia have turned to their domestic sector, through aggressive marketing of credit cards and retail loans. However, fearing another bubble, both Korea and Thailand have begun to tighten up their efforts to fire up domestic demand via these avenues. Thailand has reinstated the minimum income requirement for new credit card applicants, while Korea has implemented strict regulatory measures to curb spending. As such, unless we see better investment spending, East Asia should see slower growth in 2003. This, however, is dependent on the US economic recovery path and global tech demand. Thus, possible conflicts with Iraq, which will heighten global risk aversion and higher oil prices are probably the last thing the world wants to see. According to a British tabloid, President Bush has put 'D' day as 21 Feb 2003, which was confirmed by British defense officials that the war would begin in the 2nd or 3rd week of Feb. Although global tech demand is expected to show better performance in 2003, most are only expecting better figures to show up only in the latter half of 2003 (also contingent on the broader implications of the US possible conflict with Iraq). In the region, the Bali bomb blasts effectively meant that the war against terror has spread beyond the NY twin towers. Although the world has shown that it can live with the changing global environment, the Bali incident will nonetheless increase the risk premiums of flows (both equities and FDIs) into the region. NE Asia was earlier thought to have been from this mess, till N Korea announced plans to restart its nuke program. Reports suggest that N Korea would be equipped with nuclear capabilities within 30 days. In all, investors will have to prepare for some bumpy rides over the next few months, although we

believe that the global environment will look more positive in the latter part of 2003.

Asia GDP: Market expectation vs actual figure

	Q3-02	Market expectation	Q2-02
Singapore	3.90%	5.00%	3.70%
Malaysia	5.60%	5.60%	3.90%
Thailand	5.80%	5.70%	5.10%
Indonesia	3.90%	3.50%	3.80%
Philippines	3.80%	3.80%	4.80%
Hong Kong	3.30%	3.00%	0.80%
China	8.10%	7.80%	8.00%
Taiwan	4.77%	4.20%	4.00%
South Korea	5.80%	6.30%	6.40%

Source: CEIC, UOB

Increasing intra-regional trade (particularly exports to China)

China is now Korea and Taiwan's top export destination (after the US). The question is whether China (accounting for one fifth of the world's population) will be an alternative growth engine for the world? We doubt so. Although there have been increasing intra-regional trade (esp increasing



Asia GDP: Projection For 2003

	2003 — forecast (Dec 02)	2002 — forecast (Dec 02)	2002 — forecast (Sep 02)	2001
Singapore	4.00%	2.00%	4.20%	- 2.00%
Malaysia	5.00%	4.00%	4.00%	0.40%
Thailand	4.00%	4.80%	4.00%	1.80%
Indonesia	3.50%	3.50%	4.00%	3.30%
Philippines	3.50%	4.00%	4.00%	3.40%
Hong Kong	2.50%	1.80%	1.10%	0.10%
China	7.50%	8.00%	8.00%	7.30%
Taiwan	3.50%	3.00%	4.00%	- 1.90%
South Korea	5.30%	6.00%	6.00%	3.00%

Source: CEIC, UOB

exports to China), a significant proportion is still intermediate goods which are eventually exported to industrialized countries. Indeed, correlation studies show that intra-regional export and exports to G7 countries average around 0.85, implying that intra-trade trade flows are still ultimately dependent on the health of G7 economies. Also, although close to 70% of FDI flows into Asia is absorbed by China, and that 20% of the world's population are housed in the mainland, China's market is relatively small as compared to developed nations. As of end 2001, China's nominal GDP is worth \$1trn, while Japan is valued at \$4.4trn, EU - \$6.5trn and US-\$9.5trn. As such, it is quite impossible that China will be able compensate weaker demand from the US, EU and Japan. It can only be at best a cushion.

Policy implication

Excess capacity and global deflationary pressure, have kept inflation rate at bay. In fact, HK, Singapore and Taiwan are expected to register negative inflation in 2002. Other East Asia nations (ex-Indonesia) will register inflation figures well below their CBs' threshold. As such, both fiscal and monetary policies are likely to remain accommodative throughout 2003. With some already encountering difficulties on the fiscal front (namely Philippines, HK, lesser extend Indonesia), there will be greater focus in monetary policy as demand-side policy management (except HK). Indeed, many have followed suit with Fed's surprise 50bps cut in early Fed, except for Malaysia and the Philippines.

Asian Interest Rate cuts since Jan-01

	Current	Cumulative cuts yields %	last change since Jan-01	Expectation (End Q103)	Expectation (End 2003)
US	1.25%	-525	06 Nov 2002 (-50bps)	1.25%	1.75%
Hong Kong	2.75%	-525	07 Nov 2002 (-50bps)	2.75%	3.25%
Indonesia	13.04%	-150	—	13.00%	14.00%
Korea	4.25%	-100	07 May 2002 (+25bps)	4.25%	5.00%
Malaysia	2.80%	-50	—	2.80%	3.00%
Philippines	7.00%	-650	15 Mar 2002 (-25bps)	7.00%	7.50%
Thailand	1.75%	25	19 Jan 2002 (-25bps)	1.75%	2.00%
Taiwan	1.63%	-300	12 Nov 2002 (-12.5bps)	1.63%	1.63%

Source: CEIC

Currency outlook

Risks of increasing twin deficits in the US and lingering fear of possible war against Iraq has kept broad USD soft in 2002. Indeed, despite the rigidity in EU and Germany on the verge of recession,



EUR is now back at multi-year highs. Newly appointed Treasury Secretary John Snow and his association with a US business roundtable that has been advocating weaker USD policy have only aggravated matters. In fact, we suspect that as long as USD depreciates in an orderly manner (with limited capital flight), a weaker USD will do well for the weak US economy via loosening monetary conditions. As such, broad USD is likely to remain weak in the months ahead (including USD/Asia). Indeed, despite numerous calls to loosen monetary policy, USD/SGD has been trading at the stronger end of the MAS policy band (most participants perceive a band of 1.5% on each side of the pivot point). Having said that, most Asian CBs are likely to remain active on their respective currencies so as to keep an under performing FX (vis-à-vis) their trade partners. They include CBC, BoK and BoT, as reflected in their FX reserves' accumulation.

Fixed FX regime

There have been numerous calls to adjust the HKD peg in 2002, including shifting towards CNY fixing of 8.28. Although this would not provide much help to the HK's economy given that it has relinquish its FX sensitive manufacturing sector to the mainland since mid-1980s, it would nonetheless provide the necessary adjustment tools to the HK economy. Note that given the peg regime, HK has effectively relinquished its monetary policy. And, with fiscal gap running at historical levels, HK is practically left with no demand-side policy option. Nonetheless, given the global uncertainty, it is definitely not the right time to rethink the peg arrangement, as it would only deal fresh blows to confidence, overshooting of FX weakness and capital flight. Overall, as long as the global environment remains uncertain, there will be calls to adjust the HKD peg. But, as global economy looks increasingly positive in H2-03, we should see lesser pressure on the pegged regime. In contrast, there have been numerous calls by international community to allow greater flexible of the CNY in light of the external imbalances. Note that China's FX reserves rose more than \$60bn in the first eleven months of 2003. The pressure became more intense after the Chinese govt said it would open up it's A-share and bond markets to foreign investors (starting 1 Dec 2002). Although various restrictions remain intact, the move is seen as an important step towards opening up China's capital market to foreign investors, including increasing flexibility on the CNY FX regime eventually. Market is currently pricing in widening of the CNY trading band to $-1/+1\%$ from the current $-0.3/+0.3\%$. However, with China still undergoing deep structural reforms, stability is what the mainland needs for now. As such, we doubt if there will be any adjustment on the CNY peg in 2003.

Malaysia's quasi-govt economic think tank has joined the IMF in calls for liberalisation of the ringgit peg regime if global economy improves. As one of the most open economies in the world (meaning that monetary policy will rely more on FX adjustment), and the soft USD mood, this seems to be right policy direction. However, the peg has served Malaysia well, and with inflation not a risk in 2003, and that the country would have to cope with uncertainty surrounding the departure of Mahathir in Oct 2003, we doubt if the govt would want to mess around with the peg arrangement. Indeed, Malaysia's has benefited by the softer USD environment, with the ringgit appreciating more than 4% since end-2001, enhancing the country's exports. As long as the global environment remains uncertain, Malaysia is likely to stick with the ringgit peg.

FX & INTEREST RATE OUTLOOK

FX Outlook

Country	Q1 2003	Q2 2003	End-Q4 2003
USD/JPY	117.0-124.0	122.0-128.0	118
EUR/USD	1.00-1.06	0.99-1.05	1.10
GBP/USD	1.56-1.62	1.56-1.62	1.65
AUD/USD	0.55-0.58	0.56-0.58	0.60
USD/SGD	1.72-1.80	1.74-1.80	1.75
USD/MYR	3.80	3.80	3.80
USD/IDR	8700-9100	8800-9300	8800
USD/THB	42.40-43.70	42.50-44.0	42.5
USD/PHP	52.50-54.00	53.00-55.00	53.0
USD/TWD	34.20-34.80	34.60-35.20	34.50
USD/KRW	1170-1240	1200-1260	1160
USD/HKD	7.80	7.80	7.80
USD/CNY	8.27	8.27	8.27

Interest Rate Trends

Country	End-Q1 2003	End-Q2 2003	End-Q4 2003
US (Fed Fund rates)	1.25%	1.25%	1.75%
EUR (refinancing rates)	2.75%	2.75%	2.75%
GBP (repo rates)	4.00%	4.25%	4.75%
AUD (official cash rate)	4.75%	4.75%	5.25%
JPY (OCR)	0.001%	0.001%	0.001%
SGD (3-mth SIBOR)	1.00%	1.20%	1.40%
IDR (3-mth SBI)	13.0%	13.5%	14.0%
MYR (3-mth KLIBOR)	2.80%	2.80%	3.00%
THB (14-day repo)	1.75%	1.75%	2.00%
PHP (overnight repo)	9.25%	9.50%	9.75%
KRW (overnight rates)	4.25%	4.25%	5.00%
HKD (discount window)	2.75%	2.75%	3.25%

Narrowly Avoided Double-Dip

SINGAPORE

With the seasonally adjusted GDP figure in the black (up s/adj 0.1% q/q on an annualized basis), Singapore has effectively avoided a double-dip. On y/y basis, the economy grew 2.6%/y after 3.9%/y rise in Q3-02. For the full-yr, Singapore registered growth of 2.2% after contracting 2.0% in 2001. The govt is maintaining its broad target range of 2-5% for 2003.

Sector	1Q01	2Q01	3Q01	4Q01	2001	1Q02	2Q02	3Q02	4Q02*	2002*
Overall GDP	5.0	-0.5	-5.4	-6.6	-2.0	-1.5	3.8	3.9	2.6	2.2
Manufacturing	2.9	-8.7	-18.9	-18.6	-11.5	-4.6	13.3	15.0	6.7	7.5
Construction	2.0	0.3	-3.9	-6.5	-2.1	-8.6	-10.2	-11.0	-10.0	-10.0
Services-Producing Industries	5.7	2.6	-0.2	-1.3	1.6	0.2	1.7	1.9	2.2	1.5

* advance estimate
Source: MTI

Outlook into 2003

Cyclical Issue

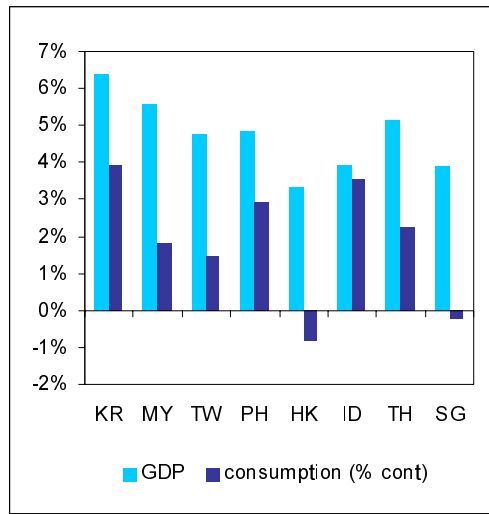
Nonetheless, outlook for 2003 remains uncertain. Although the US economy is looking slightly more positive as compared to the aftermath of the surprise 50bps Fed cuts in early Nov (as reflected in US equities rebound of 20+% since their early Oct lows), investors' sentiment remains weighed down by the much-anticipated war between the US and Iraq. Besides heightened global risk aversion, such uncertainty has kept oil prices supported, which is key to the shape of the US recovery path. Also, recovery in global electronics demand has been extremely gradual. Against projection of 10+% growth in mid-2002, global semicon sales will at best be flat in 2002. Although preliminary estimates from the Semiconductor Industry Association (SIA) are sales could pick up to 20% in 2003, much of the sales number are expected to be recorded in H2-03 (which will again be dependent on the length of the Middle East conflict and its impact on broad Muslim nations). Indeed, at his annual NY day's speech, PM Goh highlighted that full recovery will not be seen till 2004. He added that Singapore still faces structural unemployment, growing competition from China and an uncertain global economy as uncertainties in the Middle East linger. Overall, recovery in global demand, especially the US and electronics will continue to be gradual in H1-03, which will cap Singapore's growth at less than less than 2%/y in the first half of 2003.

Structural Issue

The govt's assessment (based on the latest Economic Survey) is that Singapore's economic problem is very much the result of the weak external environment. True to a certain extent, however, Singapore is also struggling with the issue of high operating cost, following the rise of China. Against an average 2.7% growth among other East Asia nations, Singapore's consumption remained in the red in Q3-02 (declining 0.2%/y). Similarly, investment spending was down a hefty 4.3%/y in Q3-02, against an average 1%/y rise in other parts of East Asia. Moreover, Singapore is now not only expensive, it has also become increasingly unsafe. Although global investors have shown to be resilient to the Bali bomb blast on 12 Oct, (as reflected on rupiah's recovery), the episode is likely to have significant impact on foreign companies' willingness to house in Singapore.

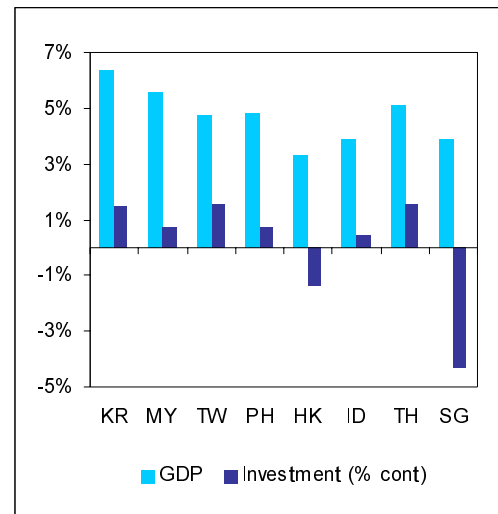


Consumption lack life (Q302 GDP)

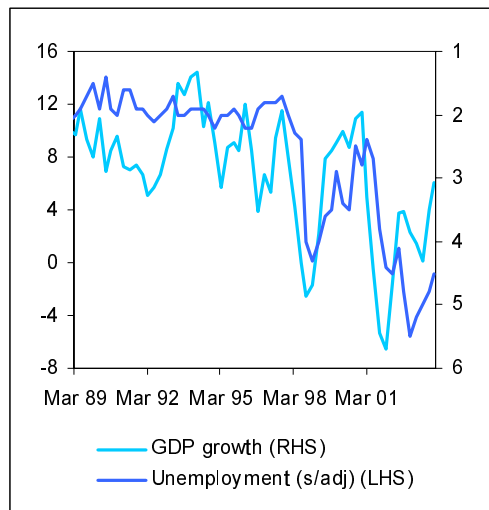


Source: CEIC

Excessive capacity remains an issue (Q302 GDP)



A jobless recovery



Source: CEIC

Irrational pessimism

No doubt Singapore is going through its most difficult times since independence in 1965. However, it is important not to fall into a sense of ‘irrational pessimism’. When global demand starts to paint a brighter picture, investors are likely to be less conscious over the city-state cost structure. Moreover, there is basis effect that Singapore could play with at least for 2003 figures. If demand would to kick in H2-03, we should see growth in excess of 6.0% in latter half of year, which will bring the full-yr’s figure closer to 4% in 2003. This is similar to the result of MAS latest survey with market economist of 3.9% in 2003.

Policy Implications

Fiscal policy

To cushion the economic downturn, Singapore has kept fiscal policy on an easing mood in 2002.

In fact, the govt has delayed the 2% point in GST (effective Jan 2003) into 2 stages – 1% point each in 2003 and 2004.

Monetary policy

Given its economic openness, monetary policy implementation has always been via SGD NEER adjustments. Increasing global deflationary pressure and limited inflationary risk till 2004, there have been numerous calls among market players that MAS should shift monetary policy bias to an easing mood. Interestingly, local newspapers reported that the CB had recently met with private sector economists. Among other issues, delivering an easing bias were said to have been discussed. However, the MAS has decided to maintain its current neutral policy stance.

Highlights of latest MAS policy statement

The MAS gave an account of SGD NEER movements over the last two quarters, saying that the local unit has been hovering around the stronger half of the MAS policy band throughout 2002. Although in the aftermath of the Bali bomb blasts, the local unit dipped slightly, it is back at the stronger half of the policy band since late Oct. this looks in contradiction to the uncertain global environment, but MAS argued it is in part of generalized weakening of the greenback — suggesting



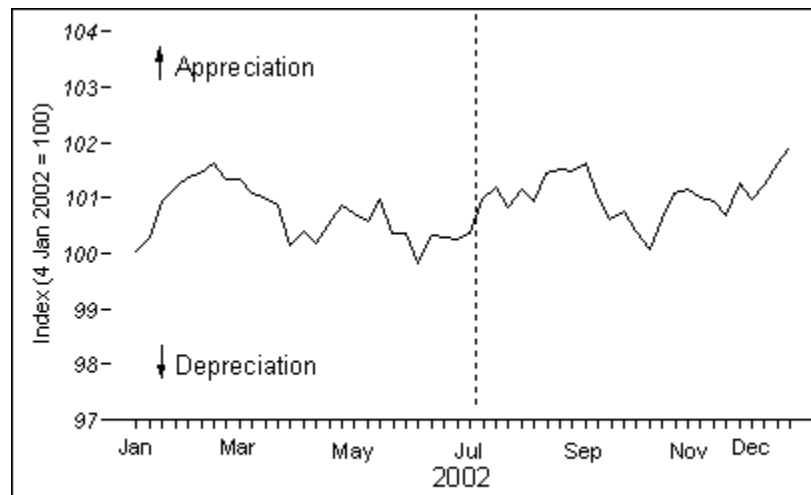
that they are comfortable with current SGD levels.

MAS indicated that outlook has become less favourable since mid-2002, as external environment deteriorated. Looking ahead, the potential conflict in Iraq poses some downside risks for the economy. As such, MAS remains negative in Singapore's outlook for H1-03. However, the CB expects a more balanced and firmly grounded recovery to kick in latter half of 2003, as external environment improves and global electronics demand strengthens. This perhaps explains why the MAS has not been willing to shift its policy bias, as any change would take about 2-3 quarters before its effects work through the system.

The CB puts 2003 inflation projection at 0.5-1.5% vs an expected -0.5% in 2002, reflecting the slack in domestic factor and product markets. On the 1% point GST hike, MAS indicated that it would be difficult for retailers to pass on the hikes given the weak consumer sentiment.

MAS has maintained its current SGD policy, with no change in the pivot point or the width of the band.

Nominal Effective Exchange Rate (\$SNEER)



----- indicates release of statement on monetary policy

Source: MAS Policy Statement

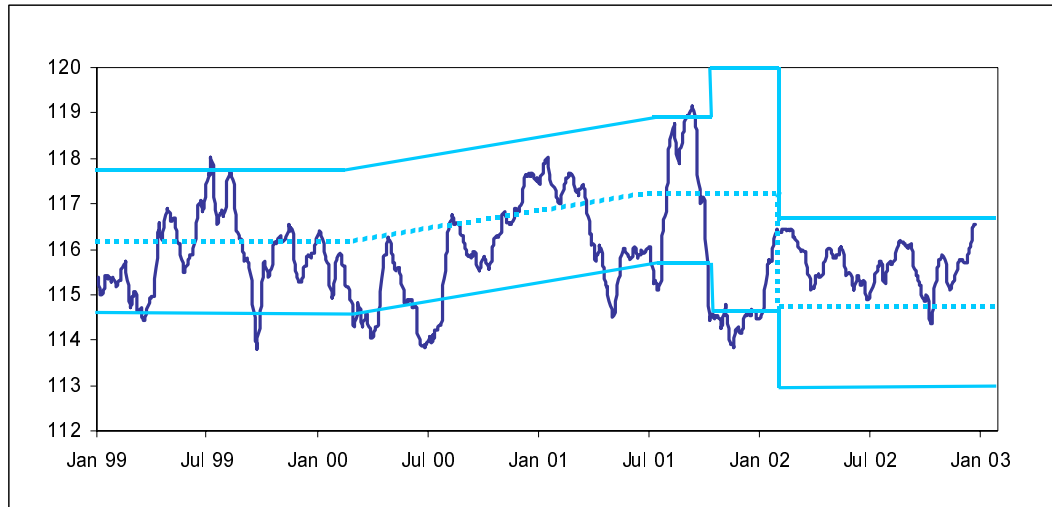
Besides brighter economic prospects in H2-03, delivering a weakening SGD policy may have serious implications. Given the size of the economy and the openness of its capital account, SGD could easily come under speculative threats. Also, the general public lacks a good understanding of the CB's SGD operation. Many still have the impression that an easing bias is synonymous to weaker SGD vs the greenback (instead of against its weighted trading partners). In fact, since its implementation of greater policy transparency, the furthest the MAS has gone is a subtle shift of its policy mid-point (Jan 2002). Also, MAS econometric model suggests that the success in Singapore's policy towards economic openness has significantly compromised the effectiveness of SGD as a monetary policy tool. As such, the question many are asking: is it worth implementing a weaker SGD policy bias and risk capital flight. Moreover, the SGD NEER band to a certain extent provides MAS with significant amount of policy flexibility.

USD/SGD call

Overall, we are back at where we started, with USD/SGD likely to track broad USD direction. In the months ahead, risks of increasing twin deficits, unclear official stance on the greenback and uncertainty over the possible war against Iraq would continue to weigh on the greenback. Indeed, we would not rule out EUR/USD eventually touching 1.06, although downside on USD/JPY may not be as extensive. However, significant SGD upside is likely to be capped by the weak domestic

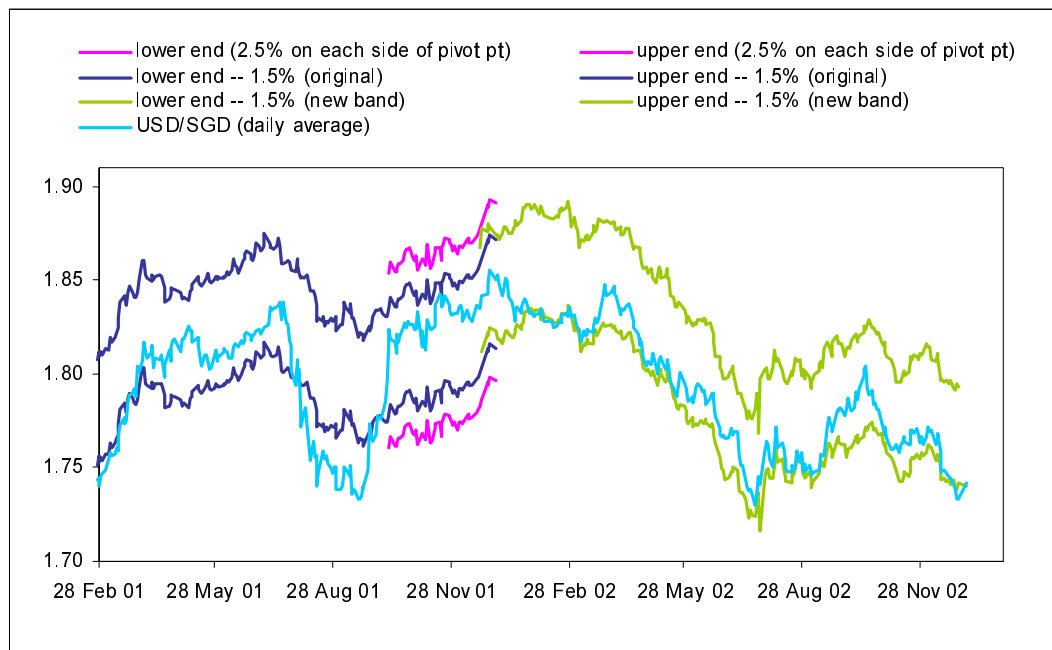


UOB's estimation of SGD NEER (daily average)



Source: UOB

UOB's estimation of SGD NEER



Source: UOB

outlook, and that SGD is closing in the MAS resolve.

Such developments are likely to keep USD/SGD fairly rangebound in the next 6 months. USD/SGD should hold above 1.72 in Q1-03, while upside should not stretch 1.78 (max 1.80) unless USD/JPY appreciate above 130 (watch the new BoJ governor's appointment).

MALAYSIA

Economy saw healthy expansion in 2002

Malaysia's Q3-02 GDP growth accelerated to 5.6% y/y, from 3.8% in Q2. The expansion was driven by sustained robust domestic demand and stronger exports performance. The largest contribution to growth came from govt spending, in line with our view of stepped-up fiscal stimulus in H2. Higher imports of capital goods was the significant factor behind the turnaround in gross fixed capital formation, which rose 2.6% y/y in Q3, after contracting in the last 4 quarters. While private consumption remained underpinned by low interest rates and easier access to financing, the pace had slowed from 5.4% y/y in Q2 to 4.0% in Q3.

Sustained robust domestic demand and stronger exports lifted Q3 GDP

	Q1-02 y/y %	Q2-02 y/y %	Q3-02 y/y %	Q3-02 ppt cont
Total GDP	1.1	3.9	5.6	5.6
Consumption	4.8	7.6	8.2	4.9
Private	3.0	5.4	4.0	1.8
Public	13.4	15.4	21.7	3.1
GFCF	-8.5	-2.1	2.6	0.7
Chge in stocks (MYR mn)	1,140	1,042	947	2.6
Net exports	-20.4	-27.9	-22.2	-2.7
Exports G&S	-6.5	3.1	11.1	11.6
Imports G&S	-4.8	6.6	15.4	-14.3

Source : CEIC

On the output side, the recovery was broad-based, led by manufacturing (7.3% y/y in Q3, vs 5.6% y/y in Q2). Industrial output is increasingly driven by the strong pickup in export-oriented industries. Growth in the agriculture sector was also robust, rising 5.4% y/y (Q2: -1.6%), boosted by higher palm oil prices. In contrast, the services sector posted slower growth of 3.4% in Q3, from 4.2% in Q2, in line with the moderation in private consumption, though there was support from tourism and trade-related activities.

For Q4 GDP growth, BNM Governor Zeti had said that it would at least match that in Q3, which would translate into full-year growth of 4.1%. Overall, despite the slightly better-than-expected Q3 GDP, we are maintaining our 2002 growth forecast at 4.0%, as there remain downside risks to Q4 performance given the external uncertainties and some easing in domestic private consumption. Govt spending is likely to be the main driver of growth again in Q4.

Can this be sustained in 2003?

The govt's forecast for 2003 growth is 6-6.5%, which appears a little optimistic in light of the uncertain external environment. We are expecting the economy to expand at a more modest rate of 5%.

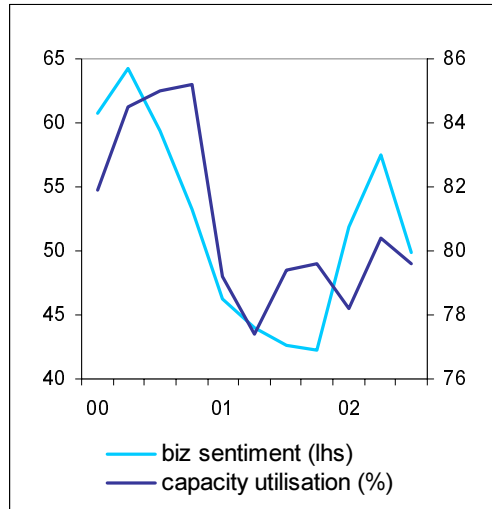
What are some of the downside risks for the Malaysian economy in 2003?

1. The recent improvements in consumer sentiment and employment conditions appear to be tapering off, and might portend some moderation in private consumption ahead.
2. Falling business sentiment in Q3 (probably in response to the uncertain external outlook) and



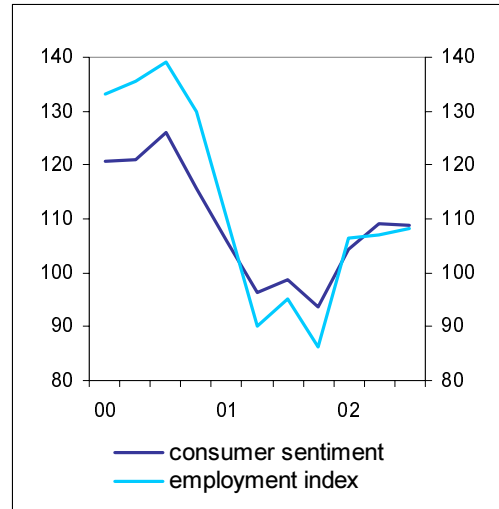
still low capacity utilisation rates (79.6% in Q3) also do not bode well for investment going forward. Latest data for H1-02 show total investment applications and approvals falling by 31% and 69% y/y.

Falling business sentiment and low capacity utilisation do not bode well for investment



Source: CEIC

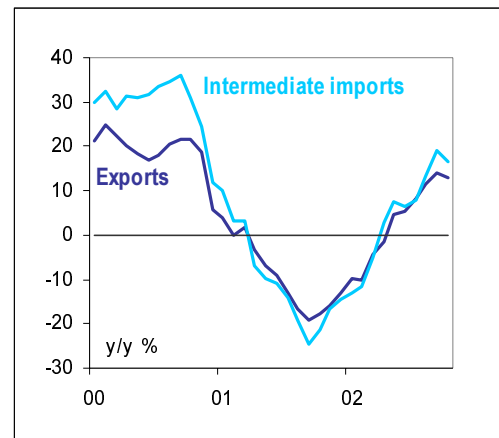
Consumer sentiment and labour market improvements tapering off



3. The still strong rise in imports of intermediate goods (12% y/y in Oct) suggests sustained export orders going into the new year. However, the recovery momentum might not be as robust, given that the global electronics sector and US economy have yet to show signs of a significant upturn and this might not materialise at least until H2-03.

Nevertheless, despite some levelling off in growth momentum, the economy will still outperform in 2003. In particular, we believe that Malaysia will have relatively greater policy flexibility in sustaining domestic demand should the external environment still not pick up in 2003.

Exports growth might be peaking



Source: CEIC

Greater policy flexibility

Despite a less expansionary budget for 2003 (deficit to be reduced to 3.9% of GDP from 4.7% this year), the relative strength of Malaysia's fiscal position and availability of funding (especially domestically where there is ample liquidity in the financial sector) do provide room for more spending should the need arise.

At the same time, the central bank can afford to keep interest rates low due to the absence of any inflation threat. Whether BNM will follow recent Fed and regional central banks' moves to cut interest rates is a close call. In an environment of a defensive USD, MYR's trade-weighted value will be kept on the soft side, i.e. some loosening in monetary conditions even without a rate cut. Also, Malaysia's current economic momentum (easing but still healthy) does not actually necessitate a rate cut. Nevertheless, given that the 3-mth KLIBOR (2.9%) is still above US rates (1.25%), there is plenty of room for a cut without sacrificing the favourable yield spread over the US and jeopardising the ringgit peg. We see possibility for a 25 bps cut by Q1-03 if the external environment still does not improve then, in order to underpin the domestic economic recovery.



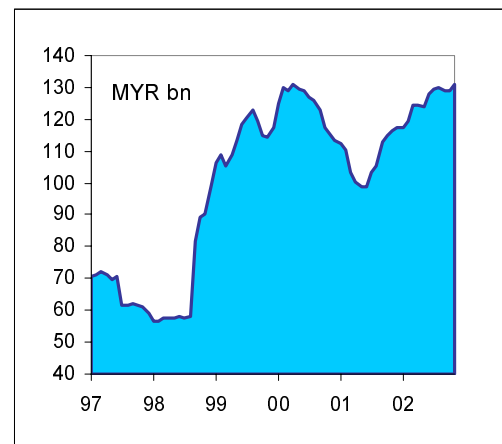
Ringgit is still competitive

In a recent assessment of the Malaysian economy, IMF urged the govt to consider returning to a flexible exchange rate in the medium term, for greater policy options in dealing with future shocks. Even though we agree that Malaysia would have to eventually rethink its peg arrangement (given its economic openness), there is no compelling reason to do so now and the current MYR value does not seem to pose a constraint to the economic recovery.

PM Mahathir has repeatedly stated that the peg will stay as long as regional currencies do not weaken too much. At the press conference after the Q3 GDP release, BNM Governor Zeti had said that the ringgit peg will be maintained at the current rate of 3.80 to USD, as it reflects

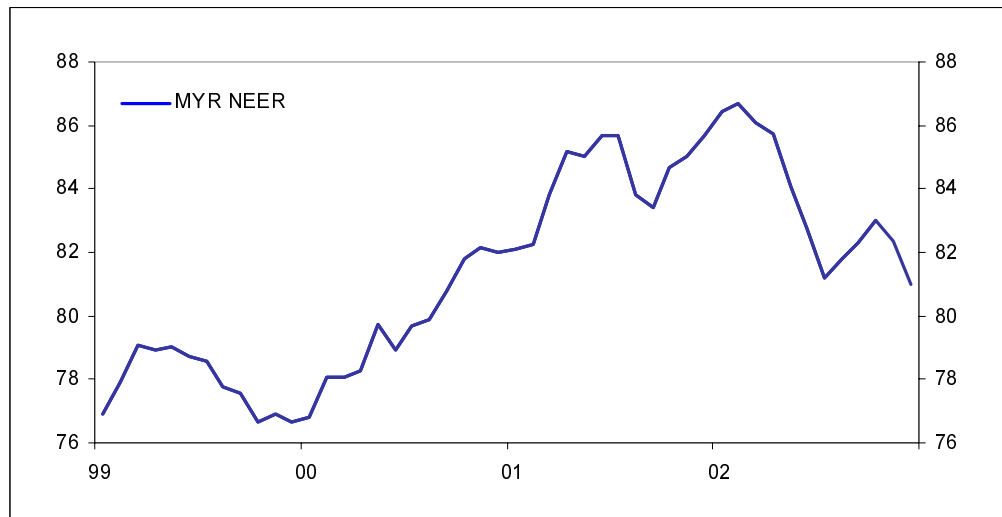
fundamentals and continues to provide stability for businesses. According to our in-house model, MYR is now 5.4% lower on a trade-weighted basis from its end-2001 level, posing no threat to export competitiveness. In fact, a calculation by Malaysian think tank MIER suggests that the MYR is 6-7% undervalued. In the near term, the broad weak USD environment and healthy foreign reserves will mean little pressure on the ringgit peg.

Healthy foreign reserves will underpin ringgit peg



Source: CEIC

Broad weak USD environment has led the MYR's trade-weighted value lower and enhance its export competitiveness



Source: UOB

Growth To Moderate Slightly In 2003

THAILAND

The Thai economy has once again outperformed in Q3-02, surging 5.8% y/y and 1.0% q/q. The recovery continues to be broad-based, with strong growth in both domestic and external demand. In particular, private consumption was the main driver again, accelerating to 5.0% y/y and contributing 2.8 ppt to overall GDP growth in Q3. private investment was also robust, led by construction with the mini boom in the real estate sector. However, public spending contracted, reflecting the pullback in fiscal stimulus in the second half of the year. On the external front, exports jumped 14.0%.

Q3 GDP outperformed again.

	Q1-02 y/y %	Q2-02 y/y %	Q3-02 y/y %	Q3-02 ppt cont
Total GDP	3.9	5.1	5.8	5.8
Consumption	4.3	3.1	3.7	2.4
<i>Private</i>	3.7	3.9	5.0	2.8
<i>Public</i>	8.3	-1.6	-3.1	-0.3
GFCF	3.2	7.5	6.9	1.5
<i>Private</i>	8.3	9.9	18.7	2.2
<i>Public</i>	-6.8	2.5	-7.9	-0.8
Chge in stocks (THB mn)	12,252	1,780	-8,377	0.6
Net exports	16.7	8.4	5.9	0.9
<i>Exports G&S</i>	5.1	12.2	14.0	8.9
<i>Imports G&S</i>	1.8	13.3	16.6	8.0

Source : NESDB

Having already expanded by 4.9% y/y in the first 3 quarters, and Oct/Nov data indicating another strong performance in Q4, the economy is likely to record full-year growth of 4.6% - 4.8%. The govt is expecting growth to hit 5.0%. The critical question going forward is whether such robust growth can be sustained into 2003?

Some moderation in growth momentum...

We believe that the outlook for 2003 will remain relatively strong, though some moderation from this year's outperformance is to be expected. NESDB is forecasting 2003 growth at 3.5-4.5%. It expects a low interest rate environment (with inflation likely to stay benign at 1.5%) coupled with various tax relief measures (including recently announced higher personal income tax exemptions and extended property tax breaks) to help sustain private consumption and investment. The lower limit of the GDP forecast range is based on a worst-case scenario of a slower-than-expected recovery in the world economy and more adverse effects of a US-Iraqi war. At the same time, the Ministry of Finance is now forecasting 2003 growth at 4-5%.

Growth to moderate next year.

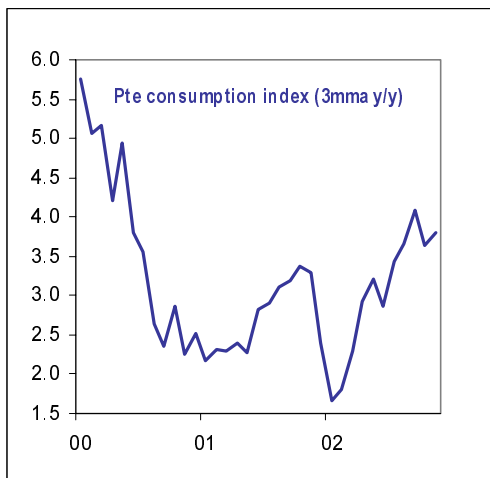
	2002F y/y %	2003F y/y %
Total GDP	4.9	3.5-4.5
Consumption	3.9	4.5
<i>Private</i>	4.3	4.8
<i>Public</i>	1.4	2.5
GFCF	7.2	7.8
<i>Private</i>	12.8	10.5
<i>Public</i>	-3.4	2.0
Exports G&S	5.7	6.0
Imports G&S	6.0	7.0

Source : NESDB

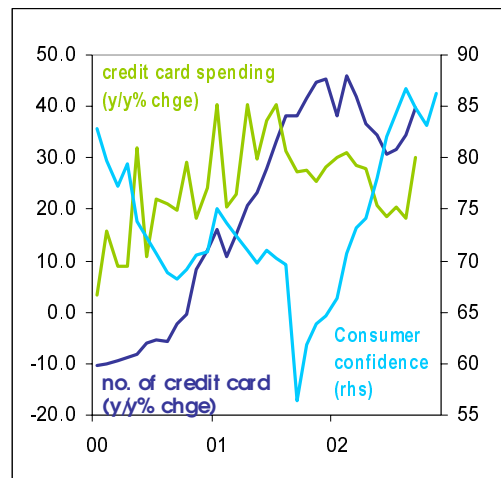


Our forecast stands at a more modest 4%. We expect domestic demand such as private consumption and investment, while still robust, to be peaking. New restrictions imposed by the govt on credit cards — e.g. reinstating the minimum income requirement for new applicants — suggest the impetus for consumer spending might ease, while global uncertainties are also beginning to weigh on sentiment. Meanwhile, capital spending is unlikely to pick up significantly soon, given the huge excess capacity still existing. In Nov, the private investment index eased to 54.3 from 56.5 in Oct, with the y/y growth moderating to 22.2% from 31.8%. The exports outlook also remains uncertain in view of a possible war risk in the first half of the year. Both businesses and to a lesser extent consumers are expected to hold back spending and this will continue to dampen global demand.

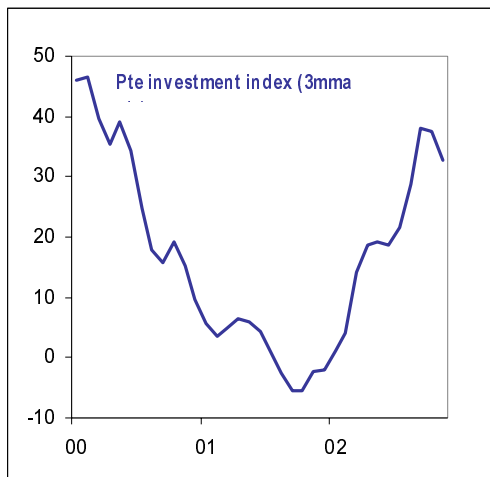
Some signs of moderation in private consumption as consumer credit and sentiment ease



Source: CEIC, BoT

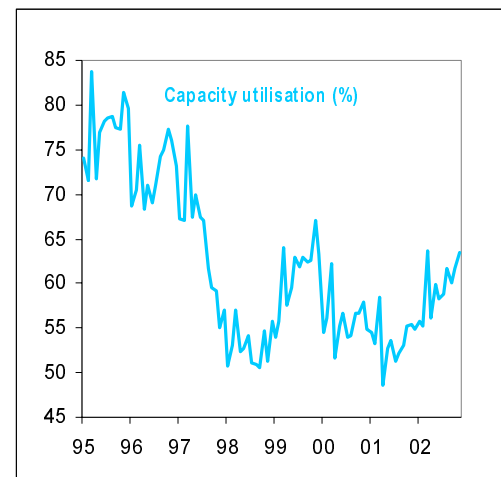


Private investment is recovering, but from a low base



Source: CEIC, BoT

Industrial production rates still below pre-crisis levels and will continue to cap capital spending



Continued support from fiscal policy ... despite longer-term constraints

With the Thaksin govt's emphasis on populist policies and stimulating domestic demand engines, fiscal spending will remain an important support for the economy going forward. While the room to manoeuvre on the fiscal front is constrained by a number of factors -- (i) high public debt to GDP ratio of 58% (68% according to IMF estimates if net contingent liabilities, mostly arising from govt's financial sector restructuring costs, are included) and rising and (ii) large interest servicing costs (taking up 20% of the govt's revenue and 4% of GDP and much higher if yields were to rise

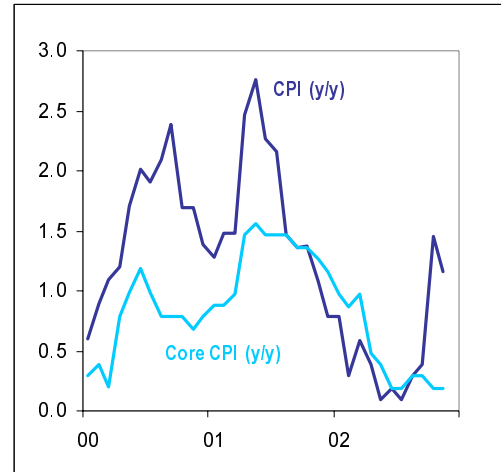


since only half of the debt is at fixed-rate) -- we see these as more of a medium term risk. Should the external environment fail to improve in 2003, the govt can still afford to undertake fiscal spending to support the economy. In particular, high domestic liquidity and low interest rates suggest no funding difficulties in short term.

Monetary stance to remain accommodative but no more rate cut for now

The external risks and more cautious outlook for the Thai economy prompted BoT to cut its 14-day repo rate by 25 bps to 1.7%% at its 19 Nov MPC meeting. We expect the central bank to stay pat for now, unless global economic conditions (especially in the US) deteriorate significantly, which is not our central forecast now. Anyway, further cutting the 14-day repo rate might not have much incremental benefit for the economy, since there is already excess liquidity in the financial system now and commercial banks have been cutting rates even without the BoT's lead. Nevertheless, the benign inflation outlook (core CPI up only 0.2% y/y in Nov) does provide room for BoT to maintain the easing bias in its monetary policy.

Benign inflation environment allows for accommodative monetary stance

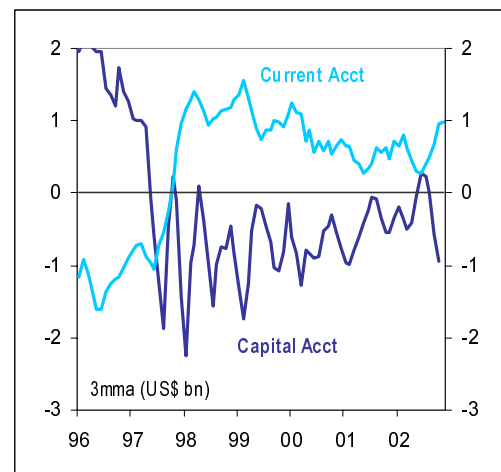


Source: CEIC

Balance of payments still going strong

The overall balance of payments position remains supportive for the THB, boosted by both rising current account surpluses and easing capital outflows (especially debt repayments). Going forward, while domestic demand is expected to remain the main engine of growth next year, imports growth will be limited by the govt's emphasis on local industries and imports-substitution, hence keeping the trade balance in healthy surpluses. The services account should also be supported by tourism receipts. The postponement of the USD1 bn global bond issue (from Nov to early 2003), the delay in the share offerings of 2 state enterprises scheduled for Nov (following Bank Thai's under-subscribed IPO in Oct) and talk of early IMF loan repayment could mean less support for the THB from a capital flows perspective, but we believe these developments are unlikely to derail the BOP surpluses.

Current account surpluses and easing capital outflows boosted the overall BOP position



Source: CEIC

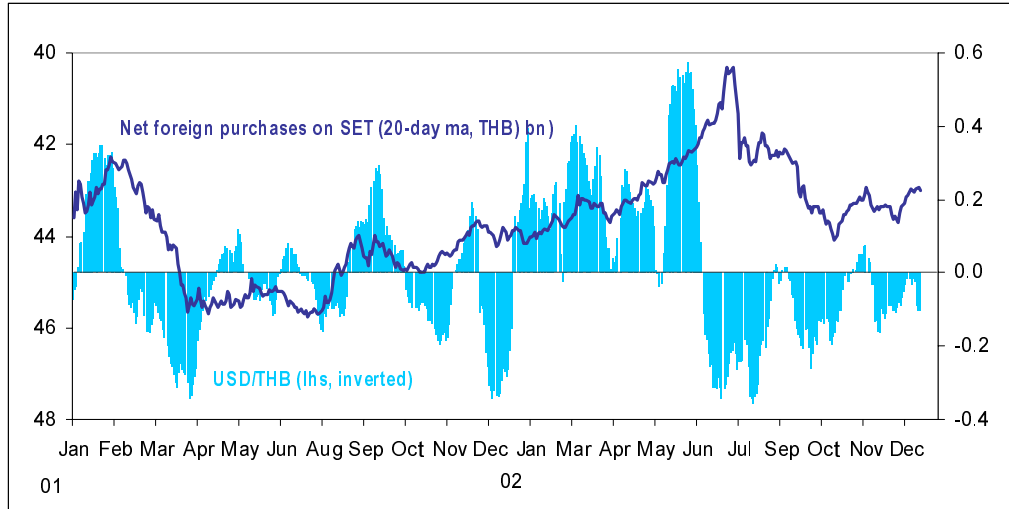
Net foreign selling on the Thai stock market has also shown signs of easing, removing a short-term downside risk for the THB.

FX implication

Despite the relatively strong BOP position and other economic fundamentals, we continue to expect THB to remain weakish on a trade-weighted basis in line with the accommodative monetary policy stance. According to our in-house model, the THB NEER is now 2.3% below its end-Aug level, when it started to fall more sharply from an observed upper range it had been trading in since the beginning of the year. However, given the backdrop of broad USD weakness as well as expected attempts by other regional central banks to cap appreciation of their respective currencies to protect exports, BoT might find it difficult to keep the THB weak. Against the USD, we are expecting a range of 42.4-43.7 for Q1.



Is foreign selling on the stock market easing?



Source: CEIC

THB remains weakish on a trade-weighted basis



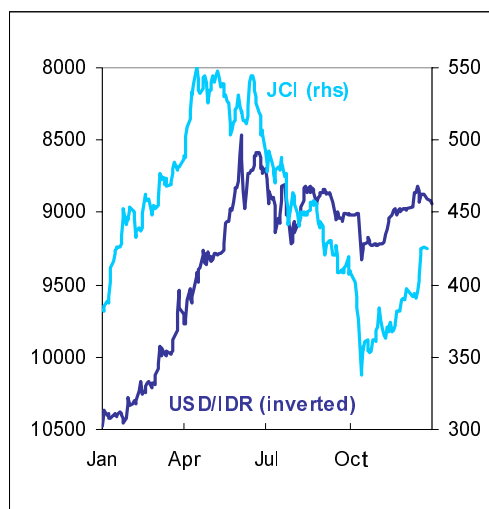
Source: UOB

What Will Be The Fallout From The Bali Bomb Blasts?

INDONESIA

Will the Bali bomb blasts on Oct 12 derail the recovery path that the Indonesian economy has been exhibiting till then? In particular, the worry is that both domestic consumption/investment and foreign investment decisions would be adversely affected by the damage caused to sentiment. Encouragingly, though the signals from financial markets in the aftermath — after the immediate knee-jerk reaction, share prices have since rebounded (JCI up 26% since Oct 14) and the IDR has stabilised somewhat — seem to suggest that investors can still live with this kind of risks now, as long as the terrorists attacks remain contained. Going forward, while the risk premium and downside risks for the country have increased, the relative macroeconomic stability in the past year and the hope that these will prove to be isolated events should help limit the damage to Indonesia's economy and financial markets.

Rebounds in stock market and JCI after Oct 12 suggest investors can live with the heightened terrorism risks



Source: CEIC

Better-than-expected Q3 GDP growth but narrowly-based

Indonesia reported better-than-expected Q3-02 GDP growth of 3.9% y/y and 2.4% q/q, with private consumption being the main driver of the economy again. A sectoral breakdown however shows that growth remains narrowly based. Agriculture and construction grew the strongest, up 6.7% and 5.7% y/y respectively, while manufacturing expanded by just 2.9%. Exports rose 1.6%, led mainly by oil products on the back of higher prices.

Domestic consumption engine running out of steam?

	<u>Q2-02</u>	<u>Q3-02</u>	<u>Q2-02</u>	<u>Q3-02</u>
	<i>y/y % change</i>		<i>% pt cont to GDP growth</i>	
Real GDP	3.8	3.9	3.8	3.9
Consumption	6.2	6.0	5.0	4.7
<i>Private</i>	5.9	4.9	4.2	3.6
<i>Public</i>	9.5	16.0	0.7	1.2
GFCF	-4.5	2.1	-1.1	0.5
Change in stks	na	na	-3.8	-1.7
Net Exports	na	na	3.8	0.4
<i>Exports of G&S</i>	-7.0	1.6	-2.2	0.4
<i>Imports of G&S</i>	-21.0	0.2	5.9	0.0

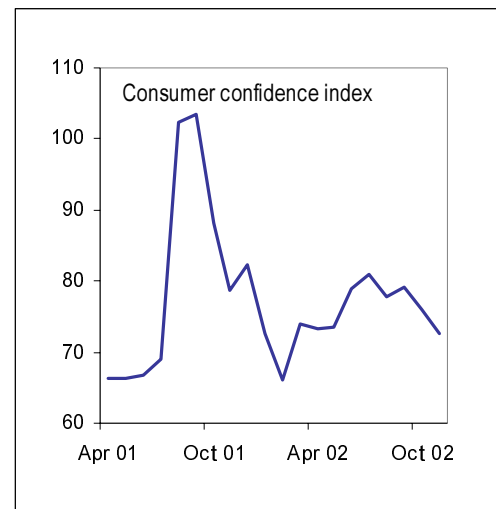
Source: CEIC, UOB



Main engine of domestic consumption looks unsustainable

Private consumption, which accounts for two-thirds of the economy, surged 4.9% y/y (boosted by auto and household sales), but was still slower than the 5.9% growth posted in Q2. Going forward, consumption is likely to continue to falter as the repercussion effects of the Bali blasts begin to filter through the economy via weaker sentiment. Consumers are likely to get more jittery about job security, with unemployment estimated to rise by a further 2 mn amidst a worsening investment climate in the aftermath of the attack. Moreover with inflation averaging 12% to-date (partly as a result of the cut in fuel subsidies) and outpacing income growth, the eroded purchasing power will further deter household spending.

Falling consumer confidence does not bode well for private consumption



Source: CEIC

Redrawing the forecasts after the Bali blasts

In light of the heightened risks to the economy from the Bali bomb blast, the govt is now forecasting 2002 GDP growth at 3.5%, vs an earlier estimate of 4%. Our full-year forecast is 3.3%, with Q4 growth seen moderating to 3%.

The govt has also revised its 2003 forecasts. GDP growth is being revised down from 5% to 4%. The most direct damage from the Bali blast has been through the USD5 bn tourism industry. Although tourism accounts only for 3.3% of GDP, its multiplier effects on the economy could be much larger. The lingering threat of more terrorist acts may also deter foreign investment, which

is crucial to the economy not just in providing the capital inflows necessary to underpin the IDR, but also the funds to finance the budget deficit. Since the Asian crisis, FDIs into Indonesia have remained at subdued levels. In the first 11 months of 2002, FDI approvals had fallen by 15% y/y. With

Revised 2003 forecasts in the aftermath of the Bali blasts

	Old	New
GDP	5.0	4.0
Inflation	8.0	9.0
Budget deficit (IDR trn)	26.3	34.4
Total govt expenditure (IDR trn)	354.1	370.6
Budget deficit (% of GDP)	1.3	1.8
3-mth SBI	13	13-14
USD/IDR	8,700	9,000

Source: Reuters

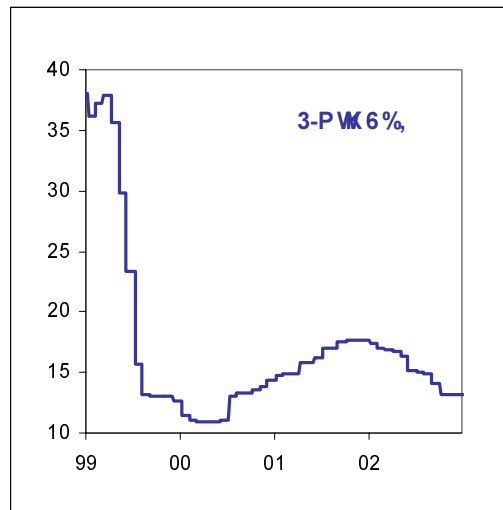
foreign investors still wary about the security situation in Indonesia, it will take time for confidence to be restored. All in all, we expect the economy to expand by less than 4% next year if the post-attack sentiment does not improve. An important factor will be the govt's success in fighting the terrorism threat.

Little scope for additional policy stimulus

In a bid to help the economy cope with the expected fallout from the terrorist attacks, the govt has approved more funds for spending in 2003, with the budget deficit expected to widen from 1.3% of GDP (IDR26.3 trn) to 1.8% (IDR34.4 trn). However, the govt's scope for additional pump-priming will be limited given its already huge debt burden and its commitments to the IMF to keep the budget on a tight leash.

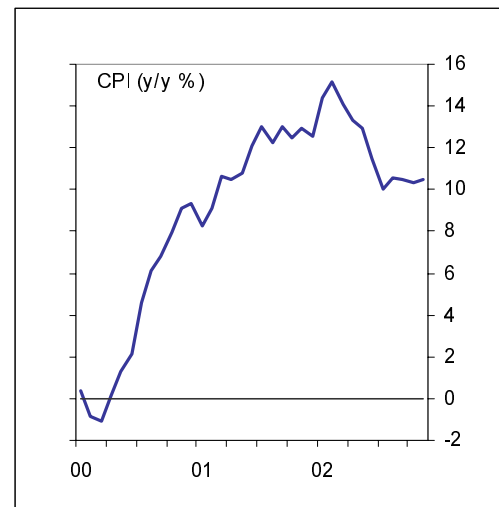


Limited scope for further decline
in interest rates...



Source: CEIC

...as inflation is expected to trend
higher with cut in fuel subsidies and
downward pressure on IDR



On the monetary policy front, the o/n intervention rate (deposit rate on commercial banks' deposits with the central bank) was cut by 50 bps to 12.125%. With weakening growth prospects, there is need for an accommodative monetary stance. However, the dilemma is that with inflation expected to trend higher and IDR likely to remain under pressure, there is actually limited room for further easing. After falling sharply since the beginning of 2002, we expect domestic interest rates to remain around current levels in near term. The govt is now forecasting 2003 inflation at 9% (up from 8%), 3-mo SBI interest rates higher at 13-14% from 13%, and the IDR weaker at 9,000 from 8,700 previously.

FX outlook

We expect the rising global risk aversion to continue to put downside pressure on the IDR over the medium term. Risk is for USD/IDR to tilt towards 9,100-9,300 by Q2, though progress in catching the suspected terrorists as well as continued IMF loans disbursements should provide some boost for fragile sentiment. We see USD/IDR in 8,700-9,100 range for Q1.

Achilles' Heel Poses Risks To The Economy

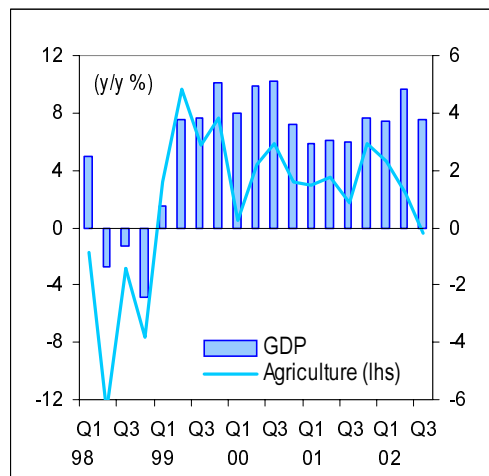
PHILIPPINES

With reported GDP growth coming in at 4.1% for the first 3 quarters, the economy is on track to achieve 4% growth for the full year. However, the Achilles' heel for Philippines remains its deteriorating fiscal position, which poses risks for the economy. The outlook for next year has also turned more cautious in view of the external uncertainties (threat of war in Iraq and global oil price increases).

A review of Q3-02 GDP performance

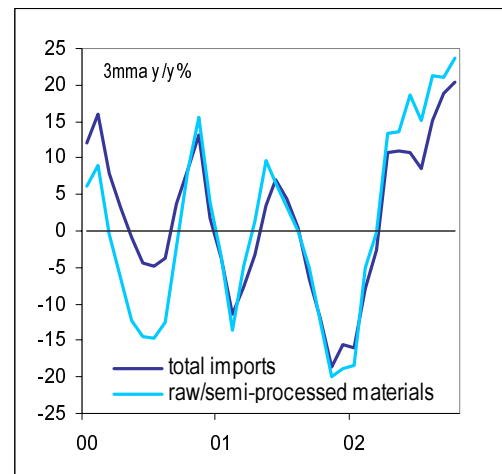
Philippines' Q3-02 GDP largely played out to our expectations. Growth slowed to 3.8% y/y from 4.8% in Q2, dragged down by weaker agricultural output. Agriculture contracted for the first time in 4 years (-0.4% y/y) in Q3, due to unfavourable weather conditions. This subtracted 0.1 ppt from GDP growth, vs a positive contribution of 0.5% in the previous quarter.

Agriculture is a drag on Q3 GDP



Source: CEIC

Still robust imports growth suggests some support for exports in Q4



Manufacturing output grew by just 1.3% y/y (Q2: 4.8%), in line with the weaker exports performance (6.2% in Q3 vs 7.2% in Q2). However, the sustained robust growth in imports, especially that of

Sustained robust domestic demand and stronger exports lifted Q3 GDP

	Q1-02	Q2-02	Q3-02	Q3-02
	y/y %	y/y %	y/y %	ppt cont
Total GDP	3.7	4.8	3.8	3.8
Consumption	2.9	3.4	3.6	3.2
Private	3.5	3.7	4.1	3.2
Public	-2.4	0.6	-0.8	-0.1
GFCF	-1.1	3.6	5.4	1.1
Chge in stocks (PHP mn)	799	3,674	3,188	-1.8
Net exports	na	na	na	-1.1
Exports G&S	-4.1	7.6	6.2	3.0
Imports G&S	-8.0	4.4	7.9	-4.2

Source : CEIC Database



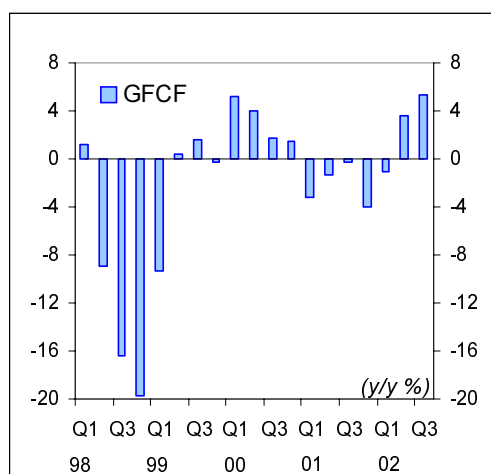
raw/semi-processed materials used as inputs in the production process, does suggest some support for the manufacturing/exports sector in Q4. Nevertheless, the uncertain path of the US/global economy (especially with war risk looming) presents a downside risk going into H1-03, with any meaningful recovery likely only in the latter half of the year.

Domestic demand to moderate going forward

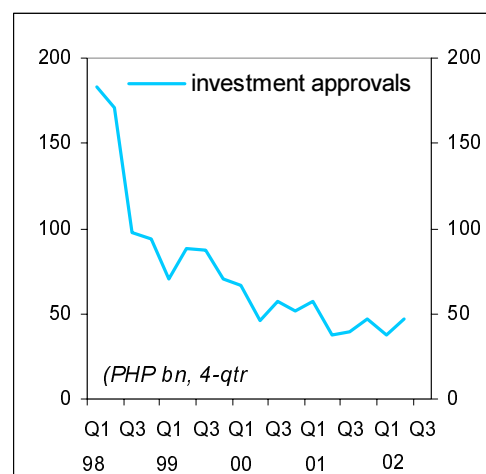
Private consumption accelerated to 4.1% y/y in Q3, from 3.7% in Q2, making the largest contribution to GDP growth (3.2 ppt). Remittances from Filipinos working overseas (an estimated 700,000-800,000 persons sending back a total of USD600,000 per month) helped prop up household income. Going into 2003, the agriculture sector -- accounting for the largest share of domestic employment at 40% and therefore an important source of household income for most people -- is unlikely to outperform again as in the early part of this year, and this will be a drag on private consumption, as will expected higher interest rates.

At the same time, public consumption fell 0.8% y/y in Q3 and is expected to continue its downtrend as the govt attempts to rein in the ballooning budget deficit. On the other hand, capital spending rose a stronger 5.4% in Q3 vs 3.6% in Q2 (reversing 5 quarters of contractions) but the turnaround is not expected to be significant given the still excess capacity in the economy and cautious business sentiment. Investment approvals remain at very low levels.

Turnaround in gross fixed capital formation but unlikely to be at significant pace given still low investment approvals



Source: CEIC



Govt downgrades economic and fiscal targets

All in all, while we expect the Philippine economy to register full-year growth of 4% for 2002, the outlook for next year has turned more cautious. We are expecting growth to reach only 3.5% in 2003. The govt's forecast has been cut to 4.2-5.2%, from 5-5.5%, taking into account the threat of a US-Iraq war.

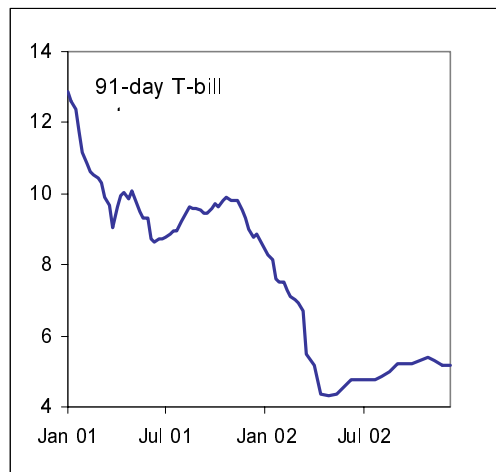
Besides the external risks as well as the slowing momentum in domestic engines, we think that the main issue for Philippines next year will remain the deteriorating fiscal position. The budget deficit for the first 11 mths of this year has already surged to PHP200.6 bn. The govt has revised up its 2002 budget deficit target to PHP225 bn (5.6% of GDP). This represents a huge jump from the PHP130 bn (3.3% of GDP) originally projected. The 2003 budget deficit ceiling has also been raised to PHP202 bn (4.7% of GDP) from PHP142 bn (3.3%). Even then, we think that the risk to the target remains on the upside. This Achilles' heel could result in significant policy constraints (both monetary and fiscal) for the govt, limiting its ability to stimulate the economy in the event of a negative shock to growth and also posing downside risk for the PHP.



Is the fiscal position sustainable?

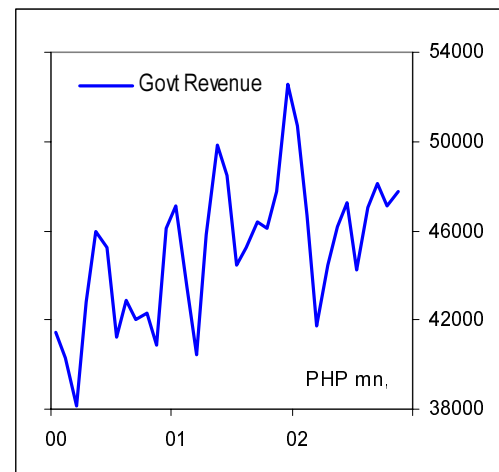
The key reason behind the deficit overshooting is the tax collection shortfall. In the period Jan-Nov, the govt only managed to take in 80% of its full-year revenue target. As a result, govt's borrowing (both external and domestic) has to be more than doubled to PHP283 bn from the originally planned PHP112 bn. So far, there has been little difficulty in funding the deficit, with the bulk coming from domestic sources. With the domestic financial system still flushed with liquidity, Treasury bond yields have remained at relatively low levels despite the increased issuance.

Domestic interest rates, though edging up since Apr, remain at relatively low levels



Source: CEIC

Recent efforts to step up tax collection seem to be bearing fruit



Going into next year, what is the likelihood that the govt can keep to its deficit target? There are signs that the recent efforts to step up tax collection (crackdown on delinquent taxpayers and restructuring of the Bureau of Internal Revenue) have started to bear fruits which will bode well for the revenue side. However, it remains to be seen whether such success can be sustained. Also, without the privatisation proceeds from the National Power Corp --from which the govt hopes to raise USD5 bn of which 25% to be paid upfront -- which has been delayed from end-02, it will be difficult to bring down next year's deficit substantially. At the same time, on the expenditure side, the govt's ability to cap spending might be constrained in view of the moderating growth prospects in 2003 as well as an impending election in 2004. An estimate by IMF suggests that the budget deficit for next year could exceed the govt's target by PHP30 bn due to pre-election spending.

Fiscal credibility will inevitably affect market's perception of the govt's financing ability, which could then prompt investors to demand higher yields on Philippine bonds. Already the market is talking of a growing possibility of a downgrade in Philippines' sovereign debt ratings, after both S&P's and Fitch Ratings lowered the country's ratings outlook to negative from stable. The resultant higher costs of govt borrowing will in turn further worsen the fiscal deficit, especially since debt servicing typically accounts for 30-40% of total govt expenditure.

We believe the fiscal situation will still remain quite dynamic over the course of next year and bears careful watching. A vicious cycle of growing market concerns about the fiscal sustainability leading to higher interest rates which translate into a wider budget deficit will be particularly damaging to the economy. Nevertheless, while it will undoubtedly become more costly for the govt to borrow (especially overseas), we do not see a funding crisis as yet, given the surplus of domestic funds.

Interest rate outlook

BSP has held off cutting rates at its last meeting on 21 Nov and 19 Dec, despite the lead from Fed and regional central banks. In particular, BSP cited inflation risks emanating from the El Nino's

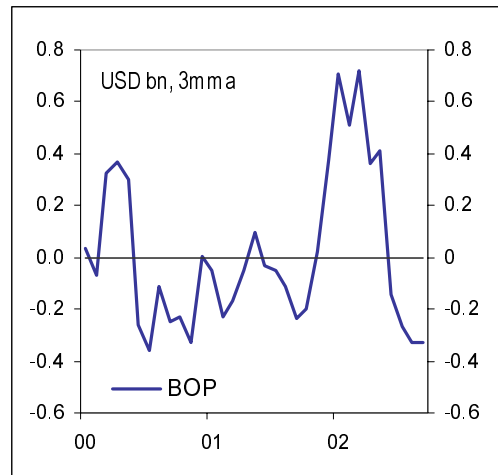


disturbance on agricultural output, Middle East tension leading to higher global oil prices as well as domestic fiscal concerns translating into inflationary expectations. The govt now forecasts 2003 inflation at a higher 4.5-5.5% vs 4-5% previously, while the USD/PHP is projected at 52-54 from 51-52. We expect inflation and currency weakness to continue to weigh against monetary easing in Philippines, with the o/n lending rate (currently 9.25%) seen edging higher by the middle of the year. However the central bank did say it will continue to monitor the economy to ensure monetary policy remains appropriate to support growth. Thus a rate cut in Q1 is not entirely ruled out should the economy falter further.

FX implications

The slowing growth momentum (which will impact negatively on revenue collection and increase need for govt spending) highlights further risks to the fiscal position, which will continue to weigh on PHP near term. In addition, latest data (up to Sep-02) show a further weakening in the overall balance of payments position, another risk for the PHP. The current account surplus continues to narrow while capital outflows (especially portfolio) intensified. Nevertheless in Q1, PHP can probably find some respite from broad USD weakness and continued remittance from overseas contract workers (which tend to peak in Q4 and Q1). We are expecting a range of USD/PHP 52.5-54.0. Beyond Q1, we expect PHP to resume its weakening trend, unless the fiscal and BOP positions show significant improvements.

A deteriorating BOP position poses another risk for PHP



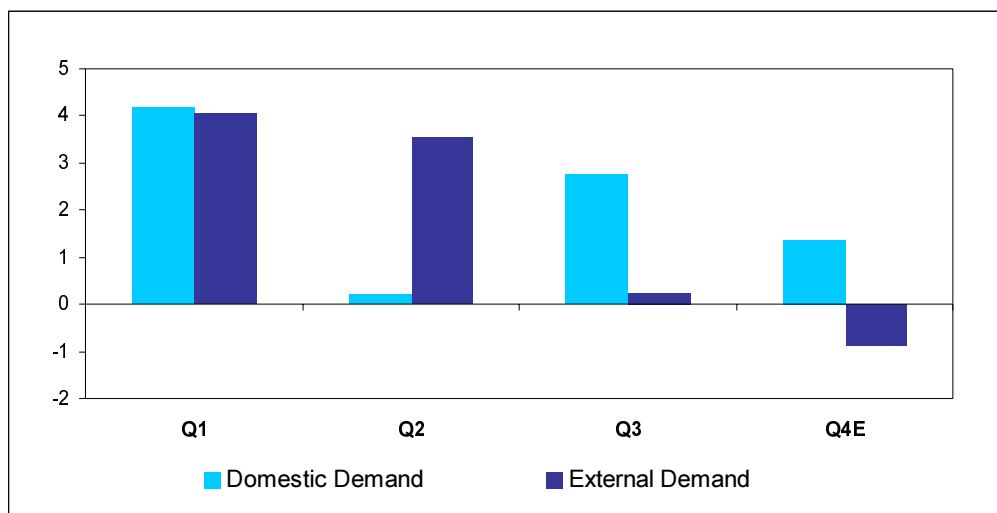
Source: CEIC

TAIWAN

3Q GDP numbers underlined falling importance of external demand

When Taiwan economy expanded a swifter 4.77%/y/y in 3Q, versus 4% in 2Q, it grew by the fastest pace in 2 years. The main theme in Taiwan's growth story this year has been external demand, but this could be changing. Net exports' contribution to GDP in 3Q was just 0.24% points, compared with 3.51% points in 2Q. Indeed, the main contributor to 3Q GDP growth was inventory growth instead. At the same time, Taiwan consumption growth appeared to be keeping up relatively well (compared to economies such as Hong Kong and Singapore). However, even though, consumption accounts for 60% of GDP, we do not see growth coming from the consumer in 2003, as spending would likely remain capped by a high jobless rate. In spite of interest rates at record low levels, private investment growth saw only modest growth in 3Q mostly aided by the expansion in inventories, and Taiwan's slow resolution of its NPL problem so far means that investment growth is unlikely to be jumpstarted going forward.

Importance of external demand engine is slipping



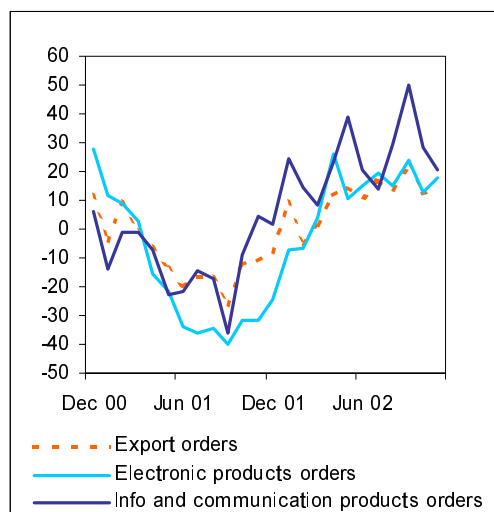
Source: CEIC, DGBAS

Modest recovery in electronics demand next year

We take the view that electronics demand next year would be modest. According to SEMI (Semiconductor Equipment and Materials International) November's survey, capex spending growth is likely to stay muted, and it does not see a stronger recovery until 2004. Underpinning this prognosis is that companies are less likely to expand capacity when inventory levels are high relative to anticipated demand. War fears are capping demand at least until latter half of 2003. Supporting this view as well is market researcher Gartner Inc. which said that weak end product market demand would likely to weigh on chip demand. Indeed, many tech companies maintained a cautious outlook on demand up to 2Q-03, perhaps as it is difficult to see beyond and it is anybody's guess how long the potential US-Iraqi war would last.

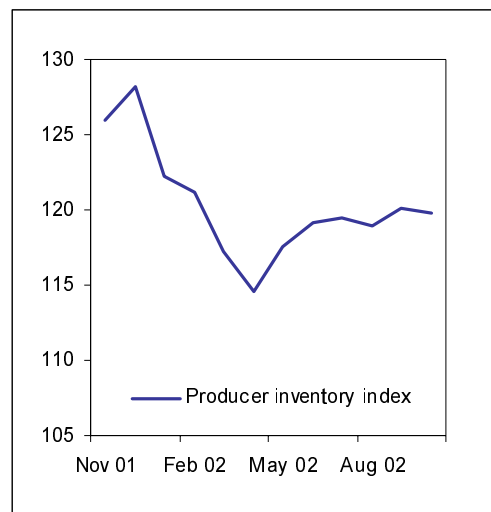


Orders growth showed signs of slowing down (y/y %)



Source: CEIC

Inventory levels picking up



Most of growth expected in latter half of year

Our projections for 4Q GDP is likely to be less bullish than 4Q, as external demand engine weakened. Full-year, we are expecting about 3% growth, against the government's recently revised forecast of 3.27%. Due to the less-than-rosy external demand outlook, inventories could continue building up. Reflecting the global electronics demand cycle, we believe that most of Taiwan's recovery next year is likely to come in 2nd half. Our 2003 GDP projection for Taiwan is a cautious 3.5%/y/y.

China Factor

According to Gartner Inc., the Asia-Pacific region as a whole accounted for 33% of global chip sales in 2002. With China growth expected at 7-8% next year, this bodes well for Taiwanese manufacturers with part of their operations in China, serving the domestic market. Evidently, from latest Chinese output data, about half of China's industrial output is serving the domestic market (while the remaining half is export-oriented). Reflecting the increasing importance of greater China trade flows, Taiwan expects to record its highest trade surplus with HK and China this year since 1987, according to official figures. In terms of y/y growth rates, exports to HK and China beat all the other key export destinations such as Japan, US and Europe. On year-to-date basis, exports to HK grew 14.8%/y/y, while exports to China have expanded 104.5%/y/y for the period Jan-Nov, whereas exports to US and Europe have declined over the same period. With end-markets in US, EU and Japan staying weak, outsourcing flows would increase, and Taiwan's exports are likely to remain dependent on intra-regional trade flows in early 2003.

Still hollowing out

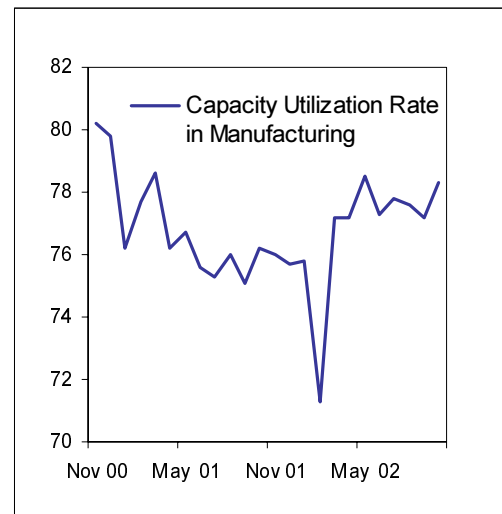
We find some truth in the hollowing-out argument as despite the Taiwan economy recovering from recession this year, capacity utilization in manufacturing has remained at relatively low levels in past 6-8 months. At the same time, China has overtaken US as its top export destination. Taiwan has been losing investments to Mainland, whereby Taiwanese businesses invested more than \$50bn in China to date. As companies shift part of their operations to China, this could worsen Taiwan's structural unemployment next year. As it makes more economic sense for Taiwan businesses to build on their links with Mainland China which expects growth at roughly 7-8% next year, restrictions on Taiwanese chip investments on the Mainland were also gradually eased, so as to allow Taiwanese manufacturers to better compete. Recently the Taiwanese government gave the go-ahead to TSMC to build an \$898mn wafer plant in Shanghai. Another Taiwanese chipmaker ProMOS Technologies lately announced plans to build an 8-inch wafer fab plant in Shanghai, to serve the fast-growing applications market (e.g. mobile phones, personal digital assistants) in China. It appeared that hollowing out phenomenon is an inevitable, long-term issue.



Hopes for closer economic integration

With Taiwan's close proximity with fast-growing China, deeper integration with the rapidly growing Mainland economy is likely to boost Taiwan's ability to attract greater investment flows. As China expands and WTO liberalization gets underway, China is becoming a key importer in the Asia ex-Japan region. Indeed, some reports have suggested that the ban on direct links between Taiwan and China may be hampering Taiwanese chipmakers from serving the China market from Taiwan itself, hence worsening the outflow of Taiwanese investment and job opportunities to China. So far, in Nov, Taiwanese airlines were allowed to operate charter flights to Mainland during the Chinese Lunar New Year in Feb. This step could pave way for deeper economic integration or outsourcing opportunities between the two.

Capacity utilisation in manufacturing has not improved

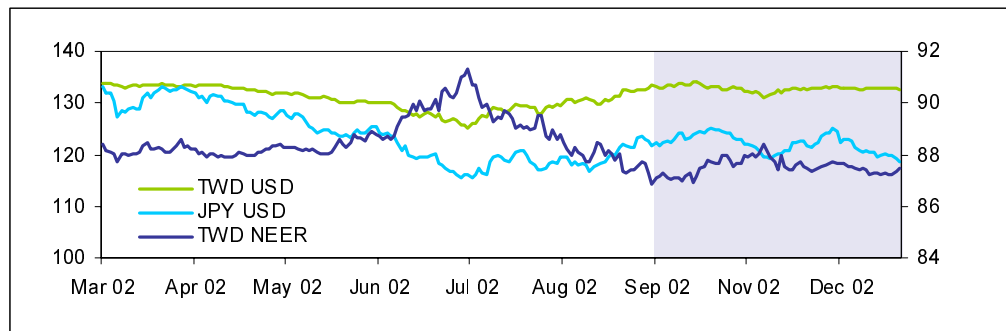


Source: CEIC

CBC policy and FX/interest rate implications

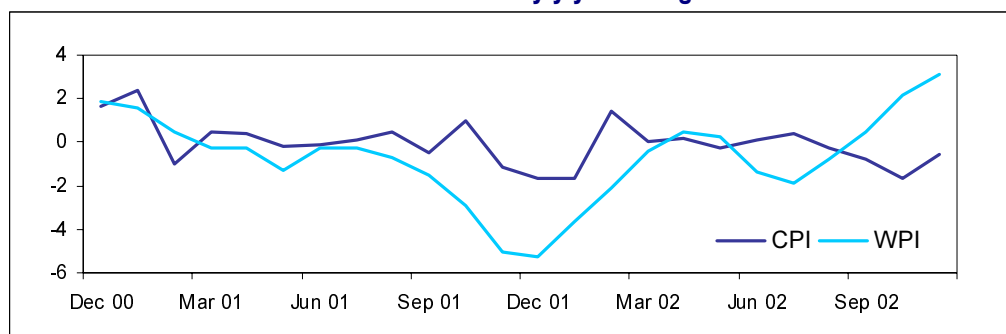
We expect CBC to maintain its weak stance for the TWD/USD, so as to maintain the export-led momentum in Taiwan's growth. That means that in a trade-weighted sense, CBC would prefer a stable and competitive TWD. Nevertheless, broad dollar weakness may lead the CBC to allow the TWD to appreciate (albeit at a measured pace), as seen during the early half of this year. While the lack of inflationary pressures would allow the CBC to cut rates, flush liquidity conditions are likely to keep the central bank from slashing interest rates further. CPI gained during recession in 2000 but contracted 0.2% in 2002. After bringing rates down in 14 moves since Dec-00, the discount rate (which is the rate at which the CBC lends to banks) is expected to stay at its current record-low of 1.625%. With the central bank expecting tame inflation in coming year, and stronger growth expected in later part of the year, chances are rates would increase towards the year-end.

JPY/USD, TWD/USD and TWD NEER



Source: CEIC, UOB

WPI and CPI monthly y/y % changes

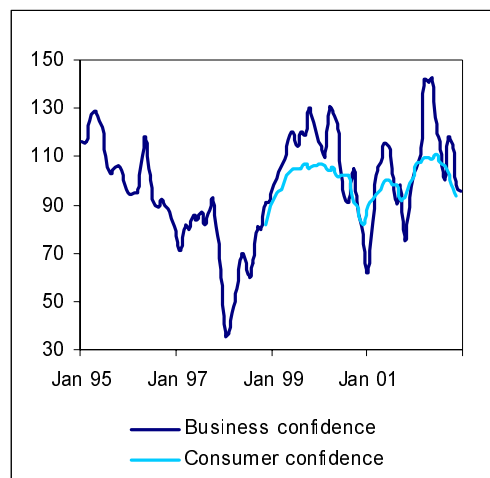


Source: CEIC

SOUTH KOREA

The Korean economy continues to impress in the second half of 2002, albeit moderating domestic demand and the weak global environment. The rebound in exports had proven to be sustainable and exports look to compensate the slowdown in consumption in the first half of 2003. Consumer and business confidence have shown signs of deterioration on the back of geopolitical tensions and slowing domestic demand and this could hamper consumer and some investment spending in early 2003 (though the recovery in exports could buoy business sentiment in the coming months). Fortunately, firm export growth is likely to take up some of the slack and the domestic economy is unlikely to experience a sharp slowdown even if global weakness is prolonged. Facility investment is also expected to pick up in the later part of H1-03, encouraged by rising exports. That said, despite the recovery in exports, the slowdown in global demand would still hamper current strong export growth and the domestic economy is likely to slow from buoyant levels in 2002. We expect domestic growth to register at 5.0-5.5% in 2003 (the optimal growth rate is 5.3%) from the projected 6.0% growth in 2002.

Declining confidence



Source: CEIC

For now, strong domestic demand and recovering exports are underpinning sentiment on the KRW. The Korean economy is also expected to outperform most Asian and major economies in 2003 and this should keep sentiment on KRW firm. However, risks of an impending war in Iraq leading to higher oil prices could hurt the KRW as Korea imports 100% of its oil and is the world's 4th largest oil importer. Nuclear threats from the North could also dampen sentiment in the Korean Peninsula and keep investors' sentiment fragile (we note that KOSPI plunged by 6.0% intra-day on 30 Dec on news of the expulsion of UN inspectors from North Korea). That said, USD/JPY movements have been the greatest dominating factor for KRW direction with domestic factors playing a lesser role. Structural weakness in the Japanese economy is likely to lead

to eventual JPY weakness and this should keep upside on KRW capped. As BoK is concerned about third-market competitiveness of the KRW (vis-à-vis its major trading partner Japan), it is likely to prefer the KRW to weaken alongside with the JPY. However, in late Q4-02, BoK tempered its firm stance, giving some leeway for resilient Korean fundamentals to be reflected on the FX front. This saw JPY/KRW shifting lower to trade in a 9.6-10.1 range (from previous 9.8-10.2). As such, in view of JPY movements and the strength of the domestic economy, we look to trade USD/KRW between 1170-1240 and JPY/KRW between 9.6-10.1 in Q1-03.

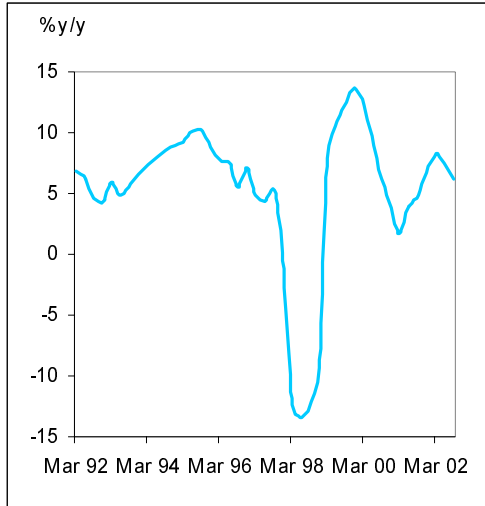
Moderation in consumer spending

It is good news that a moderation in consumer spending is finally taking place, especially after aggressive implementation of strict regulatory measures by the government to curb household debt and consumer spending. The government's efforts had proven to be effective after consumers found themselves over-leveraged. In fact, credit card delinquencies had risen to record highs in November. Monthly retail and wholesale numbers have started to decline as consumer confidence fell below the boom-and-bust line of 100 in late 2002 (lowest since Oct-01). Though unemployment rates are hovering below 3.0%, job conditions could worsen in the coming months should global



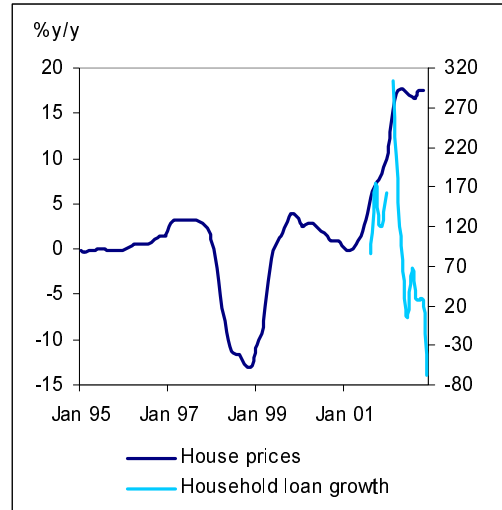
weakness perpetuate. Housing prices are also coming down and this should also contribute to a gradual slowdown in private consumption into 2003. That said, interest rates are still low by normal standards and with the BoK likely to stay on hold for most of H1-03, interest-rate sensitive sectors, namely housing, consumer credit etc, should continue to stay supported. Therefore,

Household consumption tapering off

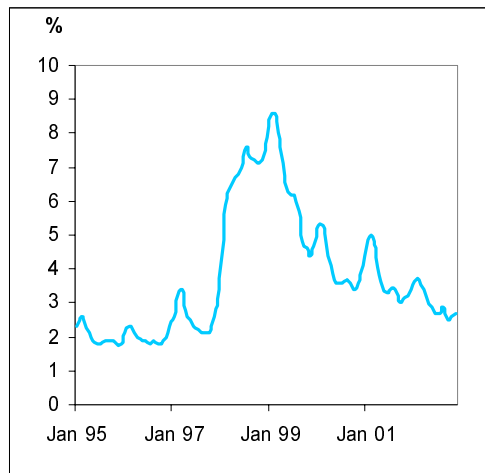


Source: CEIC

Stabilizing housing prices



Low unemployment rates



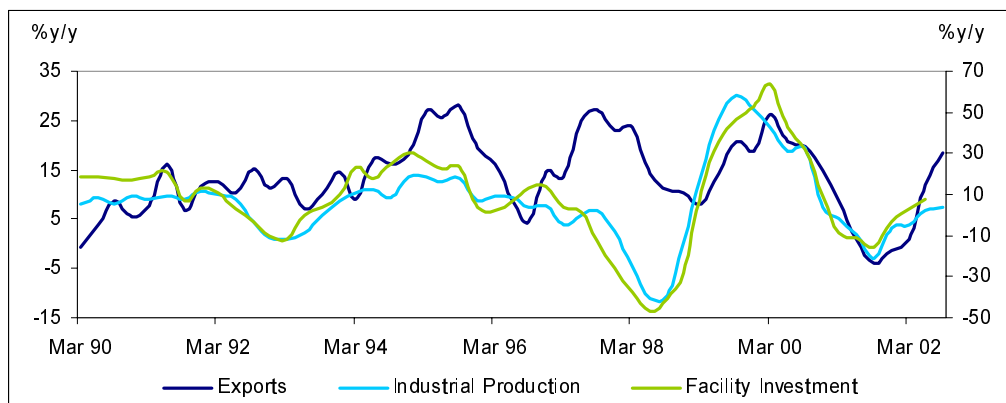
Source: CEIC

despite the fall in consumer spending, we expect low interest rates, low unemployment rates and stable growth in domestic incomes to prevent any sharp retrenchment in spending.

Can the rebound in exports last?

Consumer spending was the key driver of Korean growth since late-2001 and most of 2002, while exports were subdued amidst the global economic slowdown. However, exports had rebounded in April and had since recovered strongly. Even though US export demand has not picked up substantially in recent months, we observe from the breakdown in export data that exports to Asia, particularly China have increased significantly. In fact, Korea's exports to North-east Asian nations, including China, Hong Kong, Taiwan and Japan had accounted for

Rebound in exports and investment



Source: CEIC



34.1%, larger than the 33.2% share taken up by the US and EU. Though China's increasing export share in the global markets meant that most Korean exports to China are re-exported to the US and the export sector still depend largely on demand from the US, growing domestic demand in China did add to increasing exports to China and this should keep the Korean export sector supported in the first half of next year. Korean exports had registered over 20%/y/y for most of H2-02 (in part due to basis effect), leading to a recovery in industrial production and facility investment. In fact, BoK expects a strong recovery in facility investment in the first half of 2003. A government agency (Korea Chamber of Commerce and Industry) expects the chip industry (semiconductor chips are Korea's single biggest export item) to post a hefty growth of 20.5% in both industrial output and exports in 2003. As such, exports are expected to register strong growth in the first half of 2003 though growth could moderate in the second half of 2003 due to a higher comparison base.

BoK on hold

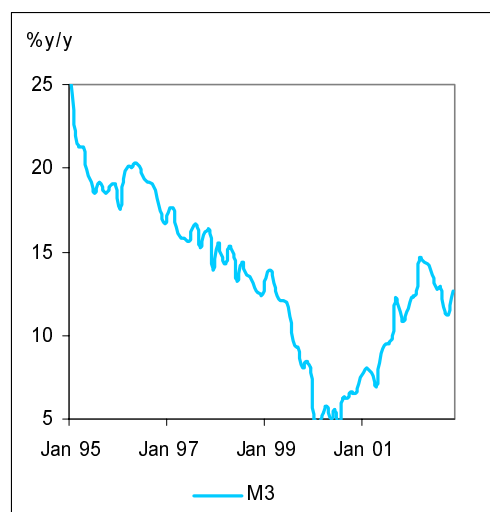
BoK expects headline inflation to rise from current benign levels of 2.7% in 2002 to 3.4% in 2003. Core inflation is expected to rise only slightly from 3.0% in 2002 to 3.1% in 2003. Higher wage and house prices (though we do not expect sharp increases seen in 2002) are likely contributors to the headline figure though easing consumer credit/domestic consumption and housing demand could keep price pressures at bay (below BoK's inflation target of 4%). Moreover, we observe that liquidity is also slowing. Concerns of rising real estate prices leading to an asset bubble, (house

Income broadly supporting housing prices



Source: CEIC

Liquidity slowing



prices have risen an average of 17% in 2002) are unlikely as thus far, housing prices have been broadly supported by income growth of an average of 12.0%.

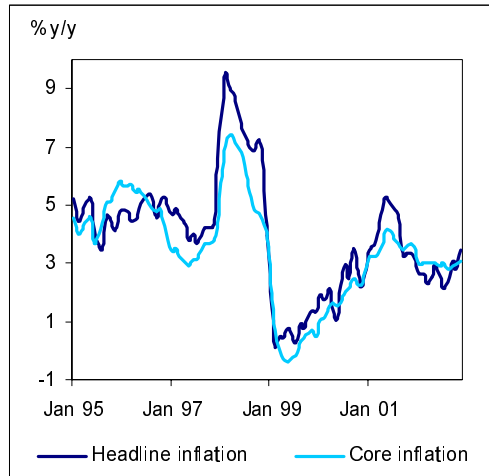
BoK maintains an optimistic outlook of the domestic economy though it remains concerned about the weak global environment and possible negative spillover effects into the domestic economy. This worry was evident in BoK's recent shift in policy bias from tightening to neutral, citing external uncertainties and stabilizing house prices as key factors. As such, BoK is expected to maintain a wait-and-see stance on monetary policy. That said, external uncertainties are likely the key focus for now and we expect BoK to remain on hold at 4.25% in the coming months. However, as the BoK remains optimistic on Korea's growth prospects, we expect BoK to be one of the first Asian CBs to resume its tightening cycle when the global economy takes flight.

Fiscal tightening

The government estimates the budget surplus to reach 2% of GDP in 2002 from 1.3% of GDP in 2001. The budget surplus was achieved largely due to higher value-added tax revenues, the sale



Inflation to edge up in 2003



Source: CEIC

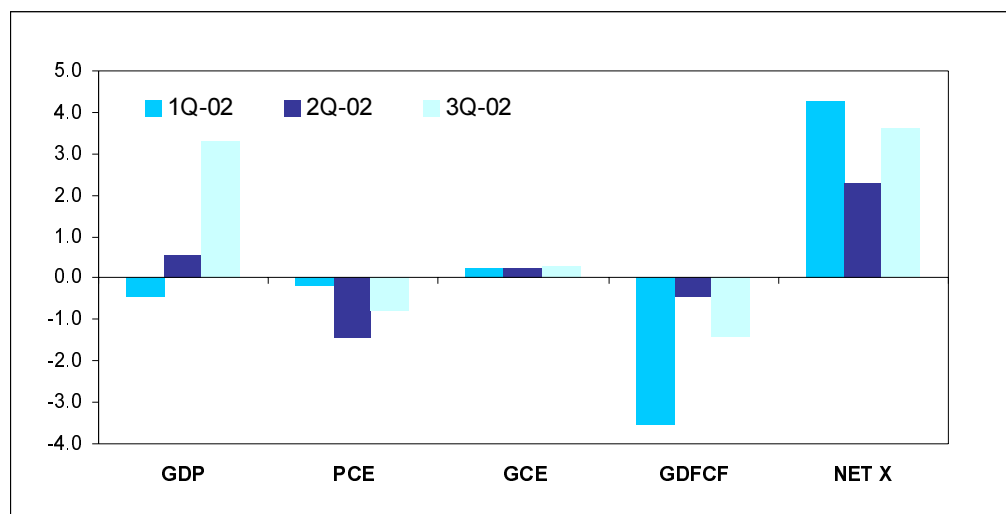
of the government's stake in KT Corp, higher contributions to the National Pension Fund and more cash carried over into the BoK's fiscal account. For 2003, the budget surplus is expected to increase to 3% of GDP in 2003. As such, fiscal policy appears to be contractionary. However, the government intends to spend about 52% of its 2003 budget (up 5.1% from 2002) in the first half of next year to aid momentum for economic growth, this should provide support for the domestic economy.

HONG KONG

3Q-02 GDP: External demand leads again

External demand has helped Hong Kong emerge from its recession, with 3Q GDP surprising on the upside at 3.3% y/y growth, beating market expectations of 3%. Again, the external sector has led the economic recovery; while private investment spending growth remained anemic. Private consumption spending contracted 1.5% y/y. Government spending in 3Q was almost unchanged as compared to 2Q (in terms of %-point contributions), underlining the view that it is difficult for government to rein in spending in times of restructuring. In the coming year, domestic consumption is likely to stay weak as it would take a longer period for the improving external economy to work through the domestic demand. This is because a broader uplift would depend on a slew of factors (including global demand recovery in 2003, economic integration with Mainland and easing deflationary spiral).

%-Contributions of GDP components



Source: CEIC

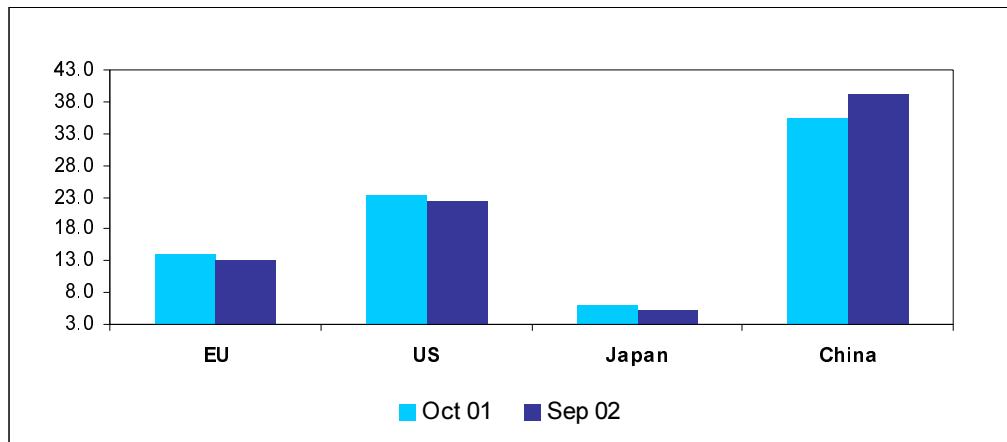
Links with Mainland lifted economic prospects

Thanks to strong transport/business links with the China market, HK trade numbers have done surprisingly well over the last few months, largely driven by re-export flows of intermediate goods into the Mainland as well as Chinese goods being exported via HK ports. At the moment, there are some signs of this upturn spreading to the broader economy. For instance, the external up-tick has helped unemployment rate declined for the 4th straight month, bringing unemployment rate to 7.1% in Nov-02, from its record high of 7.8% in Jul. Most employment gains this period was contributed by trade-related activities, real estate, finance and recreational service sectors, while employment in the business service sector contracted.

Indeed, despite falling demand in industrialized economies, the negative impacts were compensated by increasing trade activities with the mainland. Evidently, this relationship helped Hong Kong trade-related activities to emerge relatively unscathed by the US West Coast port dispute. With China expected to churn out another 7% growth this year, HK trade-related sector should continue to outperform in 2003.



**Increasing share of HK re-exports to China vis-a-vis G3
(As a % of total re-exports)**

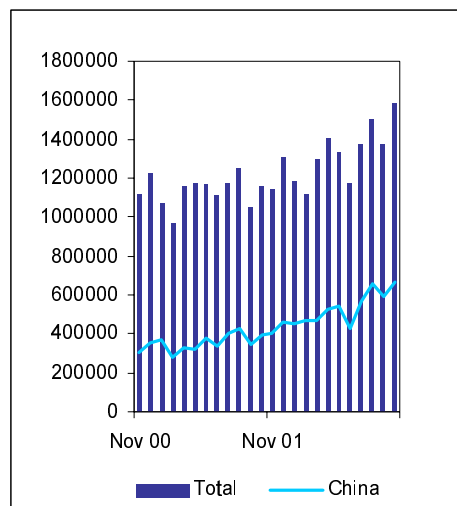


Source: CEIC

Dependent on Mainland tourism flows

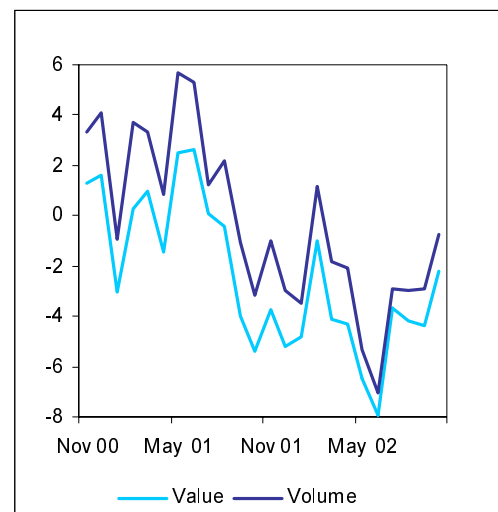
Respite are also coming in the form of increased tourism flows from nearby China, as waiting lines at the border checkpoint would be reduced to half an hour for individuals and one hour for freight. Border opening could bring forth tourism dollars. This hopefully would yield the needed multiplier effects on retail sales, hotels and restaurants trade.

Growing share of visitor arrivals from China



Source: CEIC

Retail sales spending (y/y%) - value and volume, seasonally adjusted



Deflationary spiral drag domestic demand down

CPI extended its 48th straight month of decline, dipping 3.6%y/y in Oct-02. With property prices still weak and the govt expected to cut civil servants' wages by as much as 15% this year so as to trim the government's operating expenditure, prices are likely to remain depressed in the months ahead. The territory's 180,000-strong civil service now faced the prospect of another pay cut after one just administered in Oct. Indeed, despite the fall in unemployment rate, retail sales have continued to underperform.

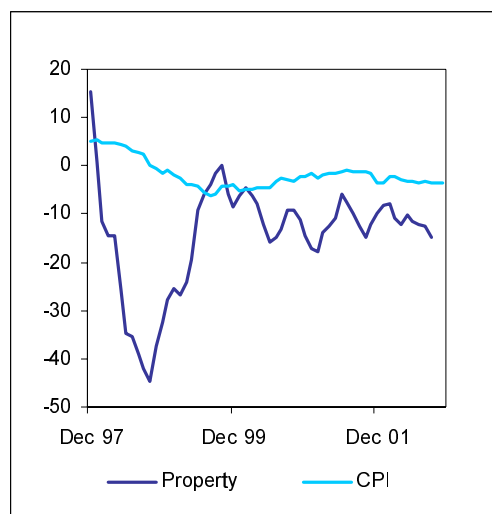
Domestic demand recovery would be weak in 2003

Property owners in negative equity are expected to add further weighs on consumer sentiment



through negative wealth effect. To counter the falling asset prices, the govt again suspended land sales. But, sources in the property market said this would only be at best a cushion. Besides the excess supply conditions, the opening of the HK-China border is likely to attract buyers to cheaper homes in Shenzhen. The move is expected to narrow the price differential between Shenzhen and HK properties, exacerbating the slide in HK private residential property prices. Indeed, despite falling more than 70% since 1997, there is yet a bottom in HK property prices, which will weigh on consumer spending in 2003.

CPI and residential property prices (y/y%)



Source: CEIC

2003 GDP forecast at 2.5%

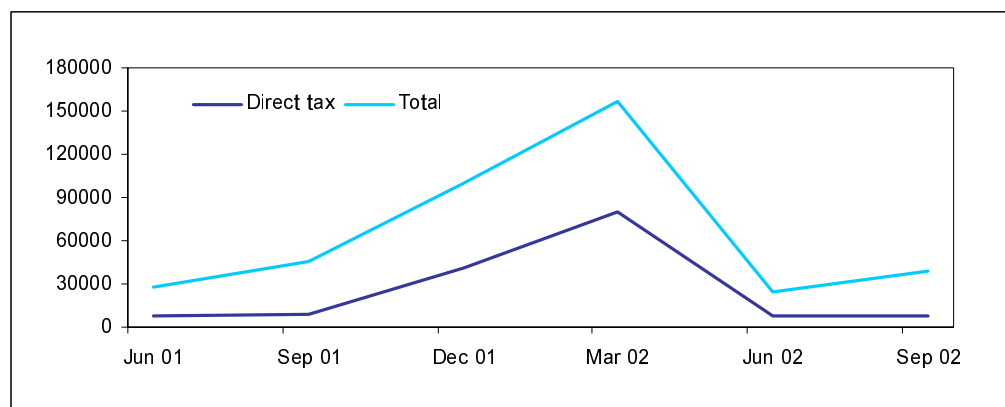
With the supports from the mainland economy, we expect HK GDP figure to again surprise on the upside in Q4. After 3.3%/y/y in Q3, we expect the headline figure to clock 3.6%/y/y in Q4-02, bringing GDP growth to around 1.8% for the full-yr. However, similar to elsewhere, the uncertain external environment will weigh on outlook in 2003, despite supports from the mainland. We expect growth of 2.5%, with most of the growth momentum likely to show up in H2-03.

Fiscal woes on radar screen...

We remain pessimistic about HK's fiscal position, as affirmed by a govt official that tax receipts collected in 2002 have come in well below expectations. The sluggish property and stock markets have also eaten into government's revenue (via stamp duties). To top

it up, HK Fin Sec Anthony Leung has told a local media that the 2nd tranche of MTRC shares would not be sold this year (which is expected to rake in HK\$15bn into the govt's coffers).

Taxation receipts expected to fall short



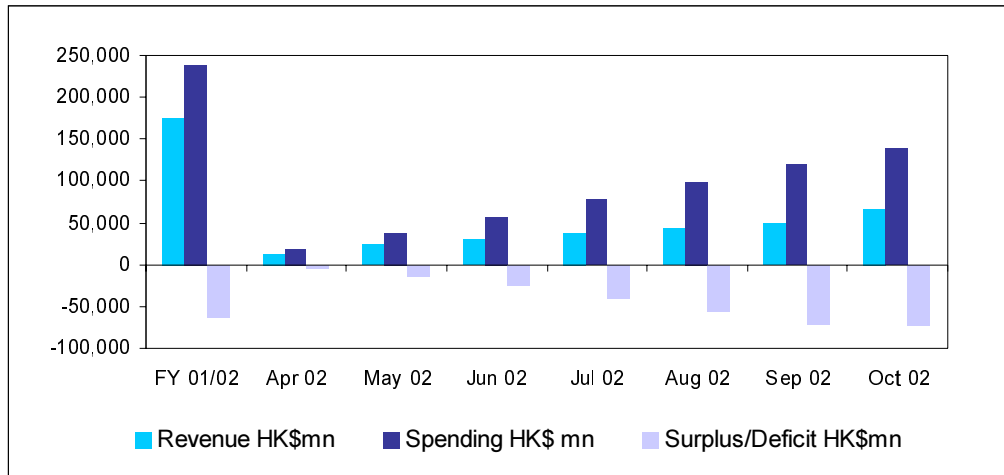
Source: CEIC

Hong Kong's middleman position intact?

A large portion of Hong Kong trade-related activities comprised of re-export of goods out of China. While a booming China economy bodes well for the SAR, Hong Kong ports are facing increasing competition from Southern Chinese ports, notably Shenzhen. As such, the direct shipments from the Mainland to overseas markets could likely restrain Hong Kong's re-export growth in the years ahead, according to the HK Trade Development Council. Nonetheless, the trade agency maintains that exports should post growth of 4.5% in 2003 (value terms).



Fiscal deficit to beat last year's record-high



Source: CEIC

Peg to stay

Although we agree that FX flexibility is much needed to cushion HK’s deflationary pressure, the lingering global uncertainties mean ‘now’ is not the time. Indeed, despite of the mounting fiscal woes (which have heightened concerns over Hong Kong’s commitment to the peg), official statements from HKSAR Chief Tung, HK Fin Sec Anthony Leung as well as HKMA chief Joseph Yam have reiterated their stand on the 19-year-old HKD peg. Even China’s Zhu Rongji has indicated that China’s sizable reserves be used to back HKD peg if need arises. However, as HK struggles through this downturn, re-peg fears will continue to linger, which will increase the risk premiums of HK assets (reflected via a steep HK yield curve).

Interest rate outlook:

On Nov 7, HKMA cuts its discount window rate by 50bps to 2.75%, after the Fed unexpectedly delivered a 50bps cut in rates. With no change in US rates till H2-03, we maintain that HK yields will stay soft throughout H1-03.

CHINA

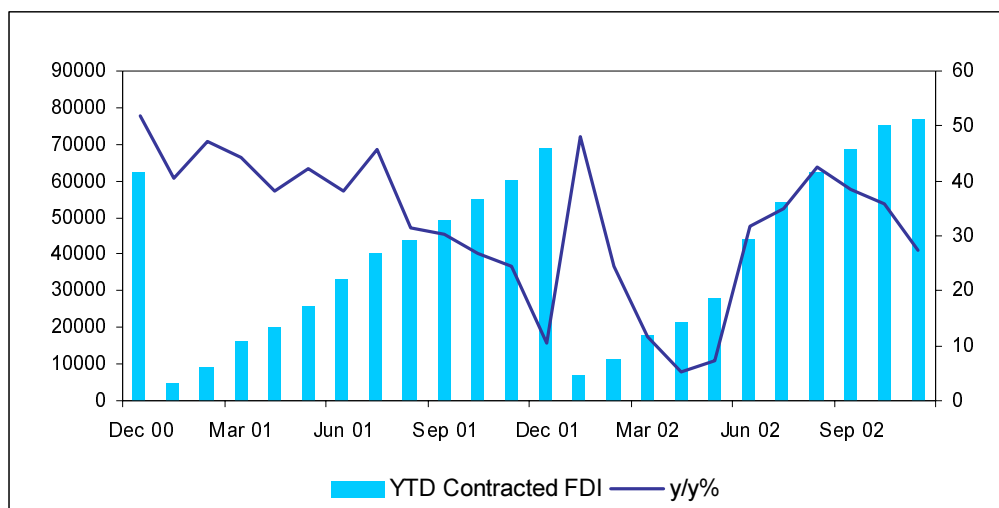
2002 GDP prelim figures

China has released its full-year GDP headline growth figure, but according to government officials, this is a preliminary result subject to revision. It grew 8%y/y in 2002 in line with market expectations according to a newswire survey, versus 7.3%y/y in 2001. China's growth has stemmed from surge in exports and steady flows of FDI, benefiting from a global outsourcing trend and the fight for a slice of China's domestic market. After expanding 8.1%y/y in 3Q, we are expecting 4Q GDP figures to be released in Feb-03. In line with global uncertainties in 2003, we expect China GDP to grow a slower 7.5%y/y in 2003.

Rising FDI, but some signs of slowing down

Economic data releases continued to affirm that China's growth prospects remain robust. However there appeared some signs of FDI slowing down ahead of the 16th National Party Congress. Our view is that the smooth political hand-over and continuing pace of reform is likely to bring back FDI flows in coming year. FDI remains a key driver for China's export-led economy as most FDI are focused in the export production sectors. Therefore steady FDI is generally a sign that China's key growth engine is intact.

Rising FDI flows, but some signs of slowdown



Source: CEIC

Deflationary risks not likely to put brakes on growth

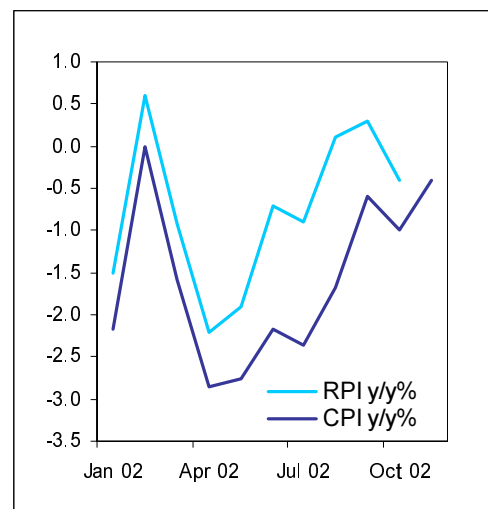
CPI and RPI data continued their trend of moderating declines. Strong import growth and retail sales suggest that domestic demand is strong and likely to be supported by rising urban incomes. Oct retail sales rose 9.4% after 9.1% growth in Sep. Import growth also grew strongly, of 28.2%y/y in Q3, and imports gain of 33.4%y/y in Oct. Credit growth was up 15.4%y/y in Oct, faster than Sep's 14.2% expansion, led by loans to industrial enterprises and the construction industry. Oct loan growth was also the fastest growth since Apr-99. Strong credit growth, as well as trade and investment flows, is likely to drive money supply growth and relieve the deflationary pressure. We basically do not see strong signs of deflation halting China's growth engine.



Growing jobless pool

The number of Chinese private companies grew to 2 million at end 2001, from 90,000 in 1998, while SOEs pared to 42,900 by end Jul-02 from 102,300 in 1989—basically, SOEs more than halved in number over past decade. In terms of implications from the 16th Congress, the pace of reform is likely to be stepped up rather than down as there seemed little ideological opposition within the new generation of leaders against moving towards a more free-market economy. The 16th congress also aimed to sell off all state holdings except for a ‘tiny number’ of strategic enterprises. But one thing is for certain, the number of SOEs will surely fall further. Hence going by these trends, China’s growing jobless pool would continue to grow even further.

CPI and RPI (y/y % change)



Source: CEIC

Will require continued fiscal boost

Last year, Beijing issued RMB150bn in bonds to support infrastructure building and job-creation efforts, as the private sector alone is not sufficient to absorb China’s growing jobless pool. The government is likely to continue with its deficit-financed pump-priming to boost domestic demand. In Jan-Oct period, FAI grew 24.3%/y. State spending is estimated to be about 30% of total GDP, and budget deficit is at acceptable levels of about 3% of GDP.

Smooth political hand-over heralds start of China’s next stage of development

The 16th Chinese Communist Party Congress ended on a positive note, with top position going to Vice President Hu Jintao, a move that is widely in line with expectations. He would head a 9-member leadership team comprising of Wu Banguo, Wen Jiabao, Jia Qinglin, Zeng Qinghong, Huang Ju, Wu Guanzheng, Li Changchun, and Luo Gan—in descending order of rank. These officials who are mostly graduates with decades of administrative experience make up China’s 9-member Politburo Standing Committee, the elite decision-making body within Chinese Communist Party’s 24-member Politburo.

To foreign watchers, they may be relatively new faces, but however, they possess strong administrative and policy making credentials, which would certainly assure foreign confidence that China stays on the reform track. As part of the political handover, a set of generational targets was also approved, which included setting a 20-year time frame to grow China economy by four-fold, from 2000-2020. In many ways, the handover is said to represent the start of China’s next stage of economic development.

Government showed resolve

Its recent move on financial liberalization represented the government’s commitment to reform. QFII, or “Qualified Foreign Institutional Investor”, represented the Chinese government’s move to liberalize its capital account for the first time. Starting from 1 December 2002, it is opening up its A-share and bond markets to foreign investors. The current size of A-share market is valued at about \$523 bn, hence despite the restrictions it is potentially a large slice of the China investment universe. Access to A-share (i.e. RMB denominated shares issued by PRC companies listed on one of two domestic stock exchanges in Shanghai and Shenzhen) was previously reserved only for domestic PRC individuals and companies.

Financial sector reform to attract long-term capital

Overall, the impact is far from a ‘big bang’ as several restrictions still existed. The scheme clearly aimed at attracting top-quality, long-term investors—as opposed to short-term speculative capital flows. QFII hence underlined the government’s gradual, conservative approach to financial sector



QFII Fact Sheet

- | | |
|-------------------------------------|--|
| 1. Start date | 1 December 2002 |
| 2. Investment quota | \$50-800mn |
| 3. Approval process | CSRC is the approving authority for QFII applications, will respond within 15 days after receiving application. |
| 4. Type of investor | Fund management houses, insurance companies, securities firms and commercial banks. |
| 5. Eligibility criteria | <p>Fund management co: at least 5 years business history; managed at least \$10bn in latest financial year.</p> <p>Insurance co: at least 30 years business history; paid-in capital of \$1bn; managed at least \$10bn in latest financial year.</p> <p>Securities co: at least 30 years business history; paid-in capital not less than \$1bn; managed at least \$10bn in securities assets in latest financial year.</p> <p>Commercial banks: Among top 100 globally; managed at least \$10bn in securities assets in latest financial year.</p> |
| 6. Investment restrictions | All stocks, treasury bonds, convertible bonds and corporate bonds listed on domestic exchanges permitted. Except shares of foreign companies listed in China. |
| 7. Ownership restrictions | <p>Each QFII can hold no more than 10% of equity shares in a listed stock.</p> <p>Total QFII holdings within a single listed company's shares cannot exceed 20% of the listed companies' total shares.</p> <p>However, CSRC may adjust requirements in line with developments of China's securities market.</p> |
| 8. Repatriation restrictions | <p>Closed-ended funds: remittance permitted in maximum installments of 20% of original quota per month after 3 years.</p> <p>Open-ended funds: remittance permitted in maximum installments of 20% of original quota per month after 1 year.</p> |

Source: CSRC, SAFE websites.

reform. In terms of implications for capital account convertibility, which remains a key medium-term policy goal for the Chinese government, QFII is seen as a step in the right direction. At present, the authorities are determined to avoid a similar crisis such as the 1997 Asian financial crisis by focusing on attracting less volatile long-term flows.



On FX flows, China's State Administration of Foreign Exchange (SAFE) would retain the rights to modify upon the scheme gradually. A recent press conference suggested that China's QFII would likely build on experiences from other QFII schemes from the region, for instance India, Taiwan and Korea. Going forward, we expect the government to modify and gradually relax the rules towards full-convertibility of its capital account. Under the current QFII, investors who wish to redeem their holdings would have to obtain approval from SAFE for the amount of money that can be converted into foreign currency, i.e. partial capital account convertibility—so that the Chinese government still controls the maximum amount of RMB to be converted.

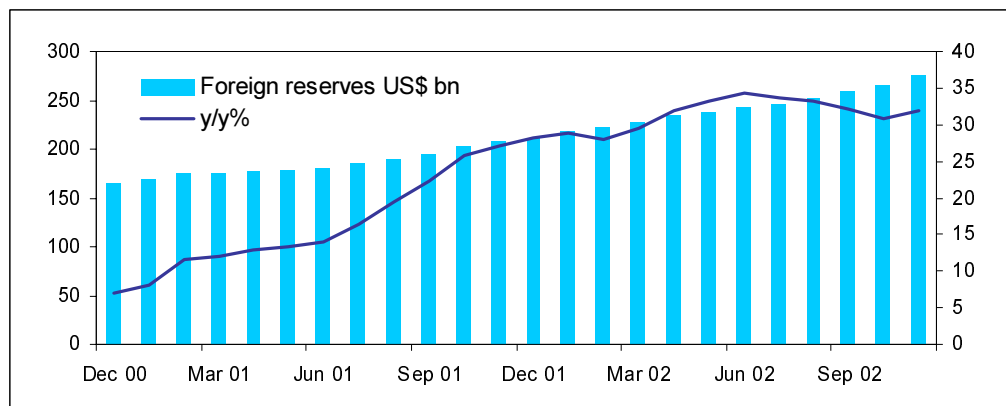
Payoffs likely to be seen in longer-term

There are a few key reasons explaining why foreign investor interest may be limited in the short term. Namely, they are due to A-share equity overvaluations, poor company quality, transparency and corporate governance issues. Repatriation restrictions also remain important concerns to foreign investors. Thus, pay-offs are likely to be seen only in the longer-term.

FX Implications: A wider trading band?

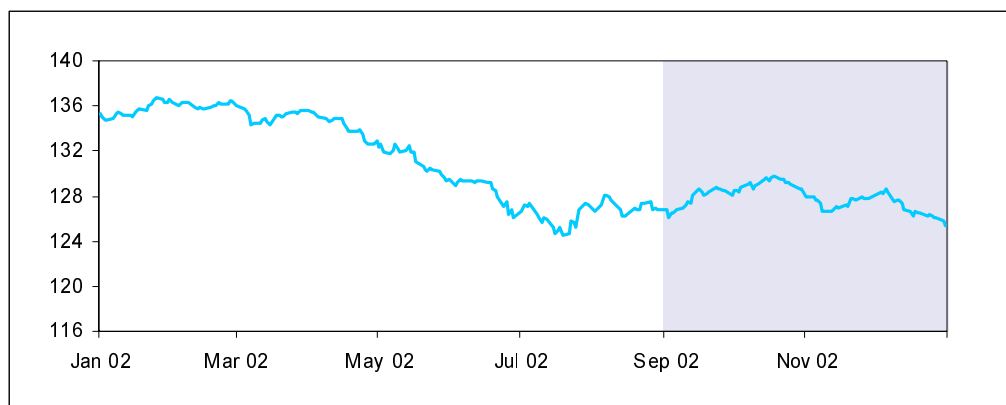
The constant accumulation of FX reserves suggests that PBOC is unlikely to allow CNY to appreciate even if the local unit floated. With the domestic economy undergoing extensive structural reforms, currency stability is likely to remain a key economic foundation. Thus we doubt if there will be any change to the FX regime over the next 2 years. Indeed, any shift will probably first begin with widening its trading band from the current 0.05% band (pivoted at around 8.278 yuan per US\$).

Constant accumulation of FX reserves (USD bn, y/y %)



Source: CEIC

Weakening CNY NEER gained in competitiveness



Source: CEIC, Bloomberg, UOB

Some Sort of Strategy To Tackle Structural Woes At Last?



JAPAN

Heading into 2003, it appears that Japan is at risk of slipping into a technical recession again as Q4 02 looks to have slipped into contractionary mode. That said, we expect any technical recession in the Japanese economy to be relatively shallow given that inventory levels are relatively low and an absence of cyclical excesses during the short rebound enjoyed in 2002 that needed to be worked away. Assuming a benign war scenario in Iraq and a gradual firming of global demand in H2 2003, the Japanese economy should be able to stage a rebound too, aided by external demand, with real GDP growth expected to pick-up to 0.5% in 2003 from an estimated -0.2% in 2002. Setting aside the by now familiar lacklustre expectations about Japanese growth, 2003 could prove to be an important year for Japan, particularly Q1, as some sort of strategy appears to be taking shape to tackle the structural woes of deflation, non-performing loans (NPLs) and industrial restructuring. Given the widespread scepticism about policymaking in Japan, we are almost hesitant in identifying any semblance of strategy to tackle structural economic woes, especially amidst extensive media reports of compromises that are seen as failures in the anti-deflation and banking reform packages. Nevertheless, two important developments have rendered it imperative to at least consider the possibility of real incipient momentum for structural changes in Japan; 1) higher probability of an accord between the BoJ and the Japanese government, and 2) policy move finally towards resolving the issues of deflation, NPLs and industrial restructuring simultaneously. The electorate's support for reforms despite economic woes is also a critical factor.

Of the myriad of policy moves by Japanese policymakers, calls for a weaker JPY and further monetary easing have garnered the lion share of attention by market players, especially with PM Koizumi widely expected to appoint someone who is sympathetic to inflation-targeting, or at the very least, further monetary easing to replace BoJ governor Hayami whose term expires on 19 March 2003. Expectations of a regime change in the BoJ and more aggressive monetary easing has led to widespread expectations of JPY depreciation, particularly when MoF officials have persistently shown a preference for a weaker JPY. Yet, against a USD that is beset by short-term geopolitical concerns and persistent underlying current account financing concerns, JPY could find it difficult to make significant downmove as preferred by the Japanese authorities. Thus, we expect USD/JPY to trade in range of 117 – 124 for Q1 with downside risks, though intervention risks would obviously rise should USD/JPY threaten to break 115. Our preference remains for playing JPY weakness against crosses, eyeing a test of 128 before 130 for EUR/JPY as long as market expectations remain downbeat about prospects of Japanese reforms. The risk is if greater market optimism about prospects of reforms in Japan coincides with an expected rebound in the Japanese economy prompts global investors to correct their significant underweight positions in Japanese equities. But that scenario is seen as one with very small probability in Q1.

Aside from monetary easing and a weaker JPY and a policy accord between the government and the BoJ following the BoJ regime change, other elements in the overall strategy that are critical are progress in NPLs disposal and industrial reform. To that end, appointments to the newly set up Industrial Revitalisation Corp (IRC) would be another key factor to watch in Q1 along with probably some corporate bankruptcies. The FSA's special inspections of the big banks' books for March book-closing would also be key. Further out, probably in early Q2, banks' action to strengthen their capital bases and dispose of NPLs would also have to be scrutinised to gauge the progress in tackling Japan's long list of structural problems. That said, even if there were genuine signs of progress in structural reforms, the process is unlikely to be a quick and cathartic one with the issue of NPL disposal and industrial reform likely to remain a drag on the economy for the next 3-4 years.



Risks to our scenario of a shallow downturn in the Japanese economy before a rebound in H2 2003 lies in a less than benign war scenario in the Middle East that tilts the global economy into a recession. JPY is at risk of a sharper appreciation if geopolitical tensions heighten to an extent that it triggers extreme risk aversion, which could see Japanese repatriation re-surfacing. Our central scenario also does not incorporate the risk of extreme volatility in the financial markets that could threaten to send vulnerable Japanese lifers or banks into insolvency that would raise fears about a systemic failure of the Japanese banking sector. There are likely to be the usual fears of credit crunch as Japanese banks step up NPL disposal efforts but we suspect these are likely to be overstated as demand for credit remains lacklustre in Japan. Witness the unchanged attitudes towards financial conditions by small firms in the Q4 Tankan despite evidence of a sharp cutback in loans to small firms by major banks during the same period which triggered outrage among Japanese politicians. Heightened political uncertainty could also be a risk to JPY assets amidst rising speculation of a snap election for the Lower House in June and signs that PM Koizumi's popularity rating slipping rather sharply again following a brief rebound in the wake of his summit meeting in North Korea. However, PM Koizumi has surprised investors and political foes alike before as he engineered a rebound in his popularity ratings following a slump after he sacked popular former foreign minister Makiko Tanaka early last year, a decision which many had thought signalled the demise of his administration. Moreover, his popularity ratings remain relatively high when compared to former prime ministers and a snap election could even deliver a greater mandate for reforms assuming the electorate maintain its support for reforms despite a deterioration in economic conditions. Nevertheless, the period of uncertainty leading to any snap election could take a toll on JPY assets.

Regime change at the BoJ and BoJ-government policy accord

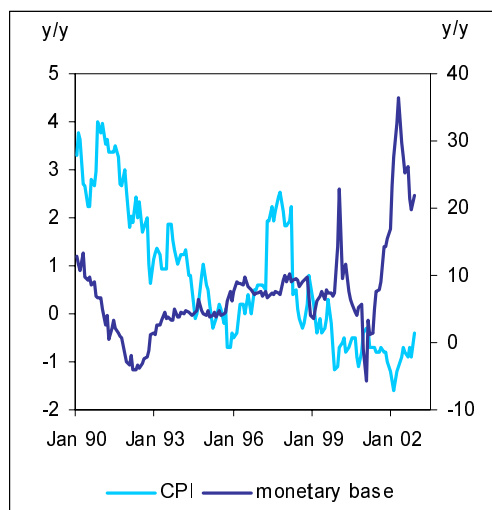
Intense focus has been on the replacement for BoJ governor Hayami when his term ends on 19 March 2003. Less noticed is the fact that the terms for deputy governors Fujiwara and Yamaguchi end on 19 March and 31 March respectively along with board member Ueda whose term expires on 7 April. Thus, within a short period of time, PM Koizumi would have the opportunity to appoint 4 replacements to the BoJ policy board which could decisively tilt the character and consensus of the board which has a total of 9 members. Moreover, within the existing board members, two, namely Nakahara and Taya, are already of dovish slant. Regardless of whether PM Koizumi picks governor Hayami's replacement from traditional sources such as MoF and BoJ alumni or from the private sector, the candidate is likely to be one who would push for aggressive monetary easing to tackle deflation. The candidate is also likely to be inclined towards inflation-targeting as preferred by Japanese politicians including PM Koizumi, even though the BoJ might not shift to an inflation-targeting regime straight away. PM Koizumi's choice of replacements would also have a direct impact of influencing an accord between the government and the central bank which had often been at odds towards tackling the issues of deflation and NPL disposal. While a BoJ-government accord could prove to be decisive in tackling deflation, the risks are for the government to shirk away from making tough decisions on structural reforms, leaning on the support of further monetary easing. Thus, investors are likely to remain, by and large, sceptical until concrete progress in terms of banking and corporate reforms are seen.

Options that could be considered by the BoJ in easing monetary policy further include 1) increasing outright JGBs purchases from JPY 1.2tn per month currently and abolishing the banknotes in circulation rule that sets the limit for total outright JGBs purchases by the BoJ. 2) increasing the amount of equities the BoJ purchases from banks (current limit of JPY 2tn) and easing the credit quality of the corporate stocks it purchases (currently BBB- and above). 3) diversifying the type of assets it purchases to perhaps even include foreign bonds and bonds issued by state lenders to facilitate debt forgiveness and credit provision to corporates. 4) providing funds to the Resolution and Collection Corp (RCC), Deposit Insurance Corp (DIC) and perhaps even Industrial Revitalisation Corp (IRC). The size and scope of the expansion of the BoJ's balance sheet would increase significantly if the BoJ were to adopt an inflation target. Adopting measures such as an aggressive increase in outright JGBs purchases and abolishment of the limit the BoJ can purchase, BoJ's action could have implications for fiscal policy too as increased JGBs absorption by the BoJ can allow the government leeway to sanction greater spending to cushion expected job losses



from NPL disposals and corporate restructuring. As long as market remains sceptical that the BoJ would be successful in triggering inflationary expectations, long-end yields on JGBs are unlikely to suffer a sharp spike. After all, despite the sharp surge monetary base in since the beginning of 2002, Japan continues to suffer from deflationary pressure and 10-year JGB yields have trended decisively below 1% again for the first time since late 1998 when Japan was in the throes of a banking crisis.

CPI still negative despite sharp rise in monetary base



Source: CEIC

Expectations of aggressive BoJ monetary easing could see a knee-jerk slide in JPY based on expectations of faster base money growth relative to the US and Eurozone. However, the theory of relative base money growth leading to weaker nominal exchange rates rest on the critical assumption that inflation differentials will widen as a result of changes in relative money supply growth, according to the PPP theory that finmin Shiokawa is fond of citing recently. Thus, for the JPY to sustain any weakness, the BoJ would have to be successful in triggering inflationary expectations and/or higher actual inflation rates. In the event that the BoJ is successful, there is likely to be a trade off between a weaker JPY and higher JGB yields and the Japanese authorities are likely to be wary of provoking a sharp sell-off in JGBs which would have a negative implications for the balance sheets of banks, who collectively had been avid

buyers of JGBs. A move by the BoJ to start buying foreign bonds could have better chances of sustaining JPY weakness. However, the need to secure the co-operation/understanding of international monetary authorities in the purchase of foreign securities as part of monetary policy operations could prove to be difficult. Already, the Federal Reserve has decided to discontinue further consideration of the possible use of foreign sovereign debt obligations as collateral for repurchase agreements in light of the "problems that were envisaged in the employment of such securities" according to the November FOMC minutes. Moreover, by directly influencing the level of foreign exchange rate of the JPY, the BoJ would be stepping on the turf of the MoF which the MoF would probably not want to concede.

The BoJ board member replacement candidates could be named by PM Koizumi as soon as late January. Or PM Koizumi could wait till the last possible moment in hopes that the appointment of a new pro-active BoJ governor would bolster market optimism during the usual stock sell-off season in late February/March period ahead of book closing. This time round the selling pressure on Japanese stocks is likely to be exacerbated by banks' interest to offload cross-shareholdings before the September 2004 deadline in order to reduce such cross-shareholdings to the limit of their Tier 1 capital. As of end September 2002, major Japanese banks still hold about JPY 20-21tn worth of listed shares versus a combined Tier 1 capital of JPY 16tn. The appointment of the BoJ governor and deputy governors would also have to be approved by both Houses of the Diet according to article 23 of the Bank of Japan law, which should ensure no lack of potential candidates being floated to the press by lawmakers in bid to influence the consensus-building process towards their favoured candidates. That said, PM Koizumi has a history of surprising markets and political pundits alike in his appointments of not just Cabinet posts but also blue-ribbon reform panels.

MoF trying to engineer a weaker JPY...

MoF officials have been stepped up jawboning for a weaker JPY in recent days in bid perhaps to alleviate deflationary pressure and forestall pressure for further fiscal expansion. Indeed, finmin Shiokawa has been pointing out persistently since mid December that the JPY is over-valued,



citing PPP fair value of 150 for USD/JPY as estimated by the OECD in 2001. (The same OECD estimates PPP value of EUR/USD at 0.88.) Finmin Shiokawa even undertook the rare exercise of penning an opinion article in the Nihon Keizai Shimbun on 20 December 2002, titled “Structural Reform Also Needed To Overcome Deflation” in which he emphasised that foreign exchange policy is one of the government’s key economic policies, and the MoF is always ready to take appropriate steps when necessary. It is rare for an economic policy maker to cite an explicit target for an exchange rate and finmin Shiokawa’s comments perhaps highlight the frustration the MoF faces in guiding USD/JPY to a more comfortable range of, say, 125-130 for Japan. MoF appears to be now hoping that further monetary easing coupled with explicit MoF preference for a weaker JPY would help the JPY to depreciate against the USD, or at the very least not appreciate sharply as the broad USD looks set to correct from its over-valued levels.

Nevertheless, as highlighted earlier monetary easing might not necessarily push the JPY weaker and the MoF would probably have to intervene on a massive scale to drive the message home to foreign exchange players that a significant appreciation of the JPY against the USD is unwelcome. Yet conducting massive intervention would be politically sensitive as the US tolerance for a higher USD/JPY is currently suspect as the Bush administration quietly drops the strong USD policy amidst efforts to reflate the US economy as the US economy struggles to get back to a sustainable growth path. Moreover, Japanese reform efforts have failed to impress so far and a weaker JPY risks diluting incentives to reform making it a dubious quid pro quo in exchange for reform efforts. In the meantime, it appears if MoF would have to continue to rely on jawboning and USD/JPY bids by proxies such as kampo and the Government Pension Investment Fund (GPIF) in bid to limit any USD/JPY downmove. Of course, any intervention to soothe the volatility of any sharp USD/JPY moves remains possible, though the only scenario where massive MoF interventions to buy USDs would be welcomed internationally is probably if there were to be any risks/fears of a destabilising capital flight out of the US akin to the immediate aftermath of the September 11 attacks in 2001. In the meantime, the MoF is expected to maintain its jawboning efforts for a weaker JPY as long as it does not foster a capital flight out of Japan by domestic investors which would have negative repercussions for JPY assets with Japanese policymakers likely to be wary of pricking the JGBs bubble in view of risks to Japan’s vulnerable banking sector.

A JPY depreciation of a magnitude that is less than say 30%, though, is not likely to be able to alleviate significantly Japan’s deflationary pressure, given that foreign exchange elasticity of the CPI is very low. As for providing support for exports, demand conditions in export destinations matter more than the exchange rate. Thus, MoF’s explicit preference for a weak JPY should perhaps be seen as an attempt to prevent risks to the Japanese economy stemming from any sharp appreciation in the JPY, which remains a threat in view of Japan’s large current account surplus (estimated 3.2% of GDP in 2002) and its status as the world’s largest creditor nation. MoF efforts at preventing JPY appreciation coupled with further monetary easing by the BoJ should help to provide a floor for the vulnerable Japanese economy as NPL disposal and industrial restructuring progresses in the next 2-3 years.

On the issue of what represents a fair value for USD/JPY depends on valuation methods. Even using the same PPP theory, the usual inherent technical considerations when constructing PPP valuations surface. The base year being employed (a year in which the exchange rate is supposedly in equilibrium) and the type of prices indices being used (CPI, WPI or export price indices) could lead to different outcomes, throwing up PPP values ranging from 80-150 for USD/JPY. Moreover, other than the issues of tradeable versus non-tradeable goods, PPP valuations also do not take into account of capital flows which by far outweigh trade flows.

Risks of a shallow technical recession...

In 2002, Japan’s GDP growth surpassed expectations, thanks not just to robust exports but also resilient consumer spending despite sluggish income and employment conditions. However, with industrial production looks to have contracted for Q4 for the first time in 4 quarters, it appears that GDP risks contracting in Q4, rendering the Japanese economy vulnerable to a technical recession. That said, as long as global demand conditions gradually firm as expected, we expect the Japanese

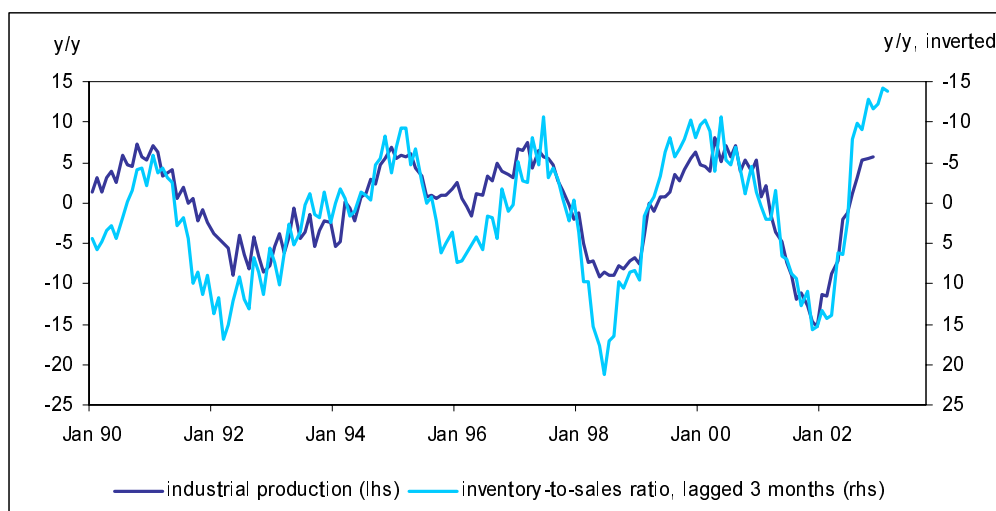


economy to only suffer a shallow slowdown given low inventory levels and an absence of cyclical excesses during the short rebound in 2002 that needed to be worked away. Assuming a benign war scenario in Iraq and a gradual firming of global demand in H2 2003, real GDP could pick-up to 0.5% in 2003 from an estimated -0.2% in 2002. An extra budget with real spending worth JPY 4.4tn and net tax cuts of JPY 1.8tn for FY03/04 should also help to provide cushion for the Japanese economy. Private consumption, though, could ease a tad following surveys showing the sharpest fall in winter bonuses to date and amid sluggish job conditions. In face of weakening consumer confidence, we do not expect consumers to keep drawing down savings as they appeared to have done in 2002. Despite a recovery in corporate profits, domestic capex remains lacklustre. As suspected, business investment in foreign subsidiaries appears to have been more appealing for Japanese corporates. In the latest December Tankan, large manufacturers have revised up their overseas capex plans by 8.0ppts to 2.5%/y/y for FY2002 while cutting back overall capex. Their percentage share of overseas investment out of total investment has increased to a forecast 31.77% for FY2002 from 28.87% in FY2001. They are also expanding overseas production, with their overseas production ratio rising to 21.17% from 20.63%. Despite fears of a slowdown in exports in response to a slowing of the American and Eurozone economies, Japanese exports have held up well, owing to firm exports to Asia. Exports to Asia now accounts for about 42% of total exports versus 31% in 1990. Firm exports to Asia has been in part due to firm domestic demand in some Asian countries and in part, FDI driven as Japanese firms set up new manufacturing facilities overseas, notably in China, benefiting exports of capital machinery. Sales of local Asian subsidiaries of Japanese firms to Europe and the US account for only 10% of sales. However, a sharp growth in reverse imports to Japan from these Asian subsidiaries of Japanese firms tends to mute the stimulative impact of firm exports.

Contribution to real GDP growth					
ppts	Q3 2002	Q2 2002	Q1 2002	Q4 2001	Q32001
Real GDP (q/q)	0.8	0.9	0.0	- 0.5	- 1.3
Domestic Demand	1.0	0.6	- 0.4	- 0.5	- 1.2
Private consumption	0.5	0.3	0.3	0.2	- 0.2
Government consumption	0.1	0.0	0.1	0.1	0.1
Gross domestic fixed capital formation	- 0.2	- 0.1	- 0.4	- 0.7	- 0.7
Changes in inventories	0.5	0.4	- 0.5	- 0.1	- 0.4
Net exports	- 0.2	0.3	0.5	0.0	0.0

Source: ESRI

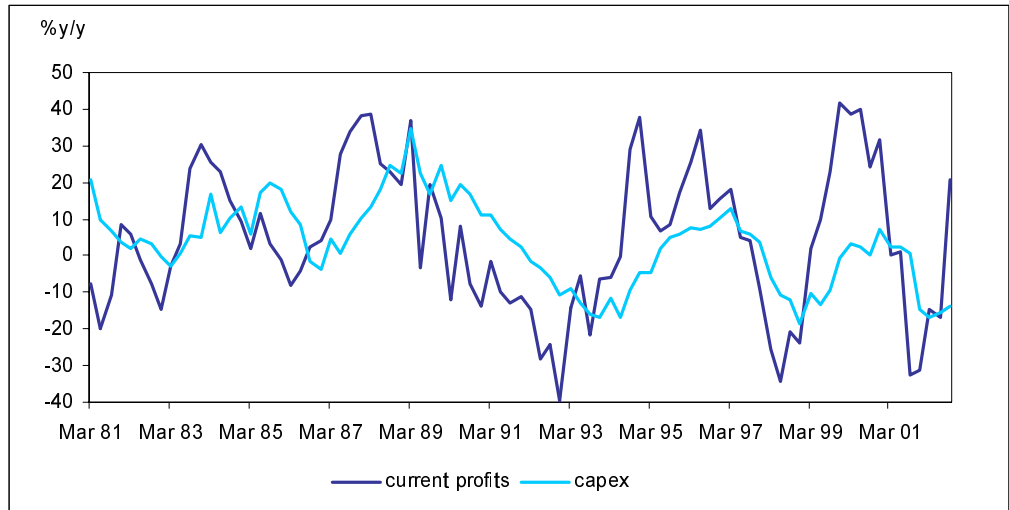
Decline in inventory-to-sales ratio suggests pullback in production to be shallow



Source: CEIC

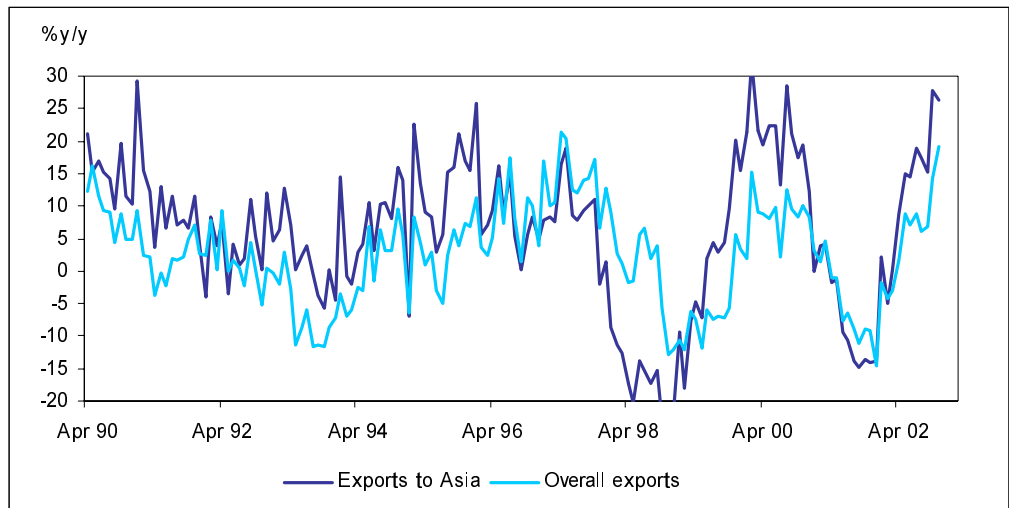


Recovery in profits fail to spark capex revival



Source: MoF

Exports still holding up



Source: CEIC

AUSTRALIA

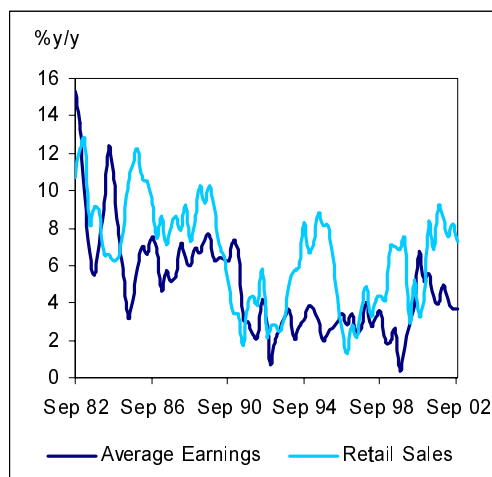
The Australian economy was in the limelight in 2002, impressing investors with a resilient domestic economy amidst the global economic slowdown. The resilience of the Australian economy was indeed evident from its growth figures. Since beginning of last year, Australia has registered strong growth readings every quarter, 4.4%/y/y in Q1, 4.0%/y/y in Q2 and 3.7%/y/y in Q3. However, as drought effects are expected to detract 0.7% from Aussie growth for 2002/03, growth projections are now at a more subdued 3.0%. Trend rate of growth is estimated to be at 3.2%. Consumer spending remains the key driver of Australian growth though there have been some signs of tapering off in late 2002. Business investment looks set to take up the slack in consumption as businesses revise up their investment intentions (in Q3-02) for the next fiscal year. Net exports continue to detract from growth on the back of weak global demand and the widespread drought. The detraction from growth is expected to exacerbate when drought effects become full-blown in Q4-02/Q1-03. That said, hopes are pinned on a recovery in exports in the later half of 2003 when drought effects fade and global recovery takes flight. Both monetary and fiscal policies are expected to remain supportive of growth as well. The RBA is expected to keep a steady hand on interest rates at 4.75% till late H1-03. In the recent mid-year budget review, it is clear that the government is determined to carry out its spending plans and we expect such fiscal stimulus to support domestic growth as well.

Favourable yield premiums had raised the appeal of Aussie assets in 2002. Broad USD weakness in H2-02 also contributed to upside on AUD. The AUD also appeared less vulnerable to global risk aversion and global cyclical risks over H2-02. However, AUD had lost some of its lustre after drought effects led to downward revisions in growth expectations. Global growth concerns also tempered speedy gains on AUD and on the backdrop of global weakness, upside on AUD could be a tad tough going. That said, we expect AUD to find a floor at 0.5500, supported by attractive yield premiums and a firm performance in the domestic economy. There is also room to test higher towards 0.5800 after a period of consolidation as Australia grows close to trend rate and continues to outperform the major economies in 2003.

Growth momentum to moderate

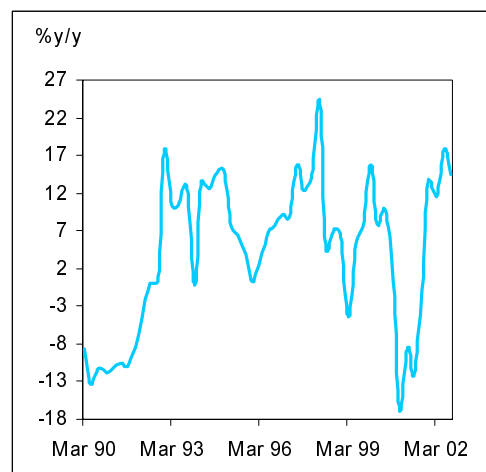
The Australian consumer was the engine of domestic growth in 2002. However in recent months,

Private consumption peaking



Source: Bloomberg

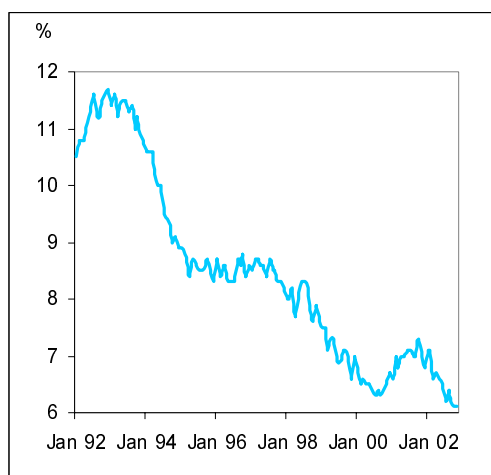
Retail sales outpace Earnings





the pace of consumer spending was seen to be gradually moderating. The retreat in consumption was evident in growth figures for Q3-02 and recent Oct retail sales data, largely due to a correction from previous buoyant levels registered in the early half of 2002. Though retail spending is likely to pick up in late Q4-02 in view of the Christmas shopping season, the pace of retail spending would likely be unsustainable into 2003. From the graph, we can clearly see that the growth in retail spending is well above current income growth rates and consumers are likely to pull back spending eventually. That said, renewed global optimism and firm jobs growth saw a recovery in consumer sentiment recently and this could provide some support for consumer spending. Unemployment rates remain steady as well, hovering around lows of 6.0%.

Steady unemployment rate

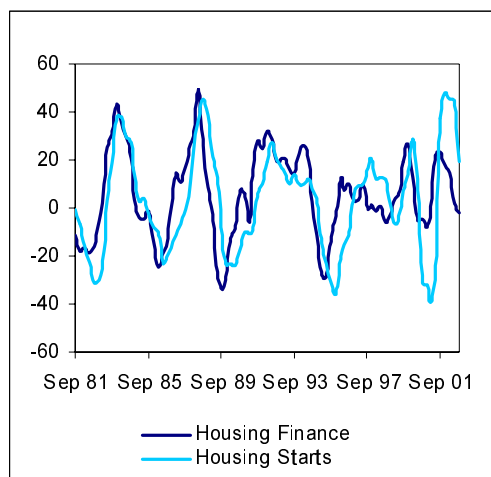


Source: Bloomberg

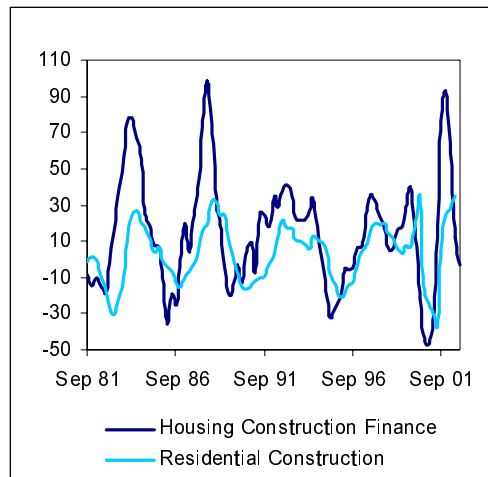
The housing sector has also continued to boom (despite calls for a correction since mid-2002) and should continue to contribute positively to growth into early 2003. However, we maintain that the housing sector is likely to slow in 2003 as housing demand indicators (see graph) have shown signs of decline since mid-2002. There are also concerns that rising residential construction amidst falling demand would lead to an over-supply in the housing market and a correction in housing prices.

There are hopes that business investment could take up the slack in overall consumption going forward. Q3 capex survey showed an upward revision in business investment intentions for 2002/03 from 8.8% in Q2 to 11% in Q3. How-

Housing sector to slow into 2003



Source: Bloomberg



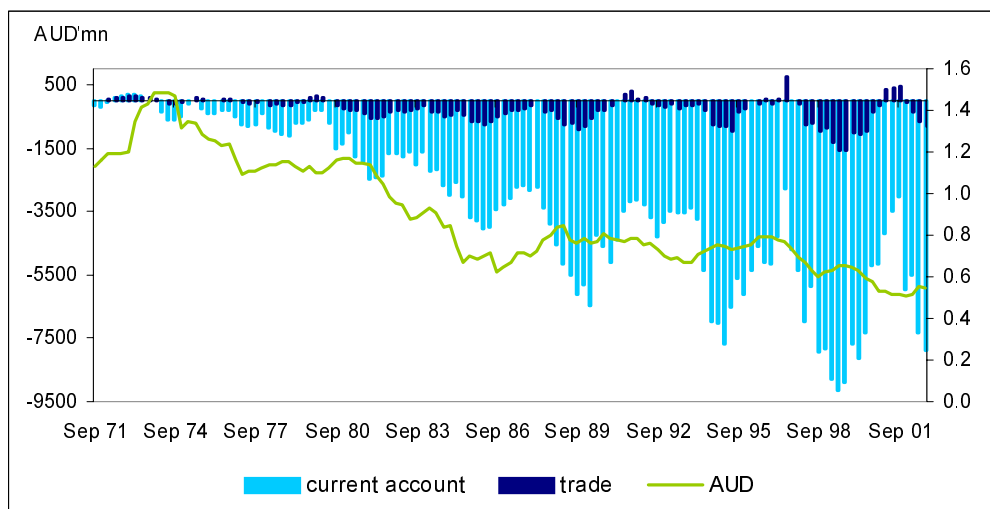
ever, recent business surveys have shown that while business conditions and manufacturing activity are encouraging, business confidence was on a decline. As such, we remain wary of business investment (often a volatile component) contributing positively to domestic growth in 2003.

Net exports continue to be a drag on growth, further aggravated by drought effects. ABARE/government projects the drought to detract a total of 0.7% from 2002/03 growth while RBA projects a detraction of 1.0%. The drought has slashed crop production by as much as 60% and the government projects a 17% fall in farm output for 2002/03. However, drought effects are expected to fade by mid-2003 and upon a global recovery, Aussie exports are likely to rebound and prop up



domestic growth. As trade deficit takes a large proportion of the current account balance, deterioration in the trade balance bodes ill for AUD in the medium-term. In fact, the current account deficit is estimated to widen from 3.2% of GDP in 2001/02 to 4.5% of GDP in 2002/03. Fortunately for now, the attractiveness of Aussie assets is compensating the widening current account deficit and underpinning the AUD. With domestic demand to moderate and exports to recover in late 2003, we expect Australian growth to register at 3.5% in 2003.

Trade - Major component of current account

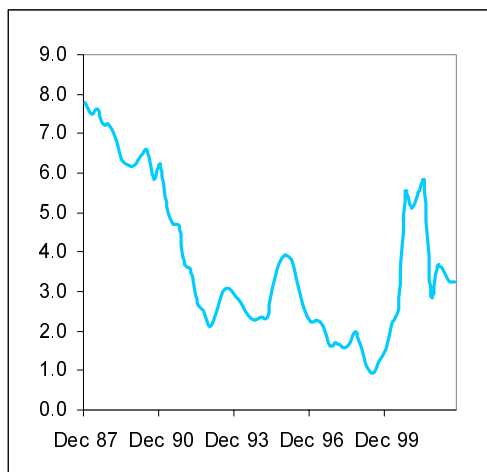


Source: Bloomberg

RBA in neutral gear

The RBA toned down its optimistic outlook, expecting the domestic economy to register 3.75% growth in 2003, assuming the drought ends and the global economy recovers in the second half of 2003. RBA estimates current underlying inflation at 2.75%, comfortably within its 2-3% target band. Going forward, RBA projects inflationary pressures to be relatively subdued and underlying inflation to register close to 2.75% in 2003. Headline inflation is also expected to eventually converge towards 2.75% in 2003 as well. This is unlike previous projections of CPI rising towards the upper end of the target band in 2003 as growth concerns keep inflation at bay. As such, unless the global economy tanks out or domestic growth risks a sharp downturn (eg growth forecasts revised below 3.0%), we expect RBA to keep interest rates on hold at 4.75% till early H2-2003.

Core inflation to trend lower



Source: Bloomberg

Fiscal spending intact

Despite downward revisions to growth forecasts of its 2002/03 growth projections from 3.75% to 3.0% at the government's mid-year fiscal and economic outlook, the projected underlying cash surplus for 02/03 was left unchanged at AUD2.1bn (0.3% of GDP) and 03/04 surplus revised up from AUD3.7bn to AUD4.9bn (0.6% of GDP). It seems surprising that despite slower growth prospects and firm government spending, underlying cash surplus projections remained intact. However, as the government attributed the downward revision in growth wholly to drought effects (maintaining 3.75% projections for non-farm 02/03 GDP), it is possible that minimal spending was/would be incurred in drought assistance and tax losses are marginal from the farm sector. As the government also projects a

rebound in 03/04 growth to 4.0% (possibly after drought effects fade), budget projections are thus



left relatively unchanged. The government said that though downside risks to the global economy remain large, the non-farm sector and business investment is expected to underpin domestic growth. However, we remain cautious on being overly optimistic on Australian growth on the back of weak global recovery prospects and would not be surprised if downward revisions are made in Australia's budget surplus should global growth fail to pick up. As such, fiscal spending remains neutral for now.

Budget forecast (AUD'bn)				
	2002/03	2003/04	2004/05	2005/06
Revenue (% of GDP)	169.6 (22.5)	180.1 (22.6)	188.8 (22.4)	198.1 (22.3)
Expenses (% of GDP)	170.7 (22.6)	177.2 (22.2)	185.2 (22.0)	192.7 (21.7)
Underlying cash balance (% of GDP)	2.1 (0.3)	4.9 (0.6)	4.2 (0.5)	5.4 (0.6)

Source: Bloomberg

EUROZONE

For the euro, 2002 is going to be remembered as the year in which the beleaguered euro appreciated over the year for the first time ever since its official launch on 1 January 1999. Starting the year at 0.9038 against the USD, EUR/USD ended the year perched firmly above 1.03 by late December 2002. However, rather than its own merits, euro benefited by default, first from US corporate accounting scandals which shattered the myth of superior US corporate governance standards, then from rising concerns about US twin deficits (current account and budget deficit) triggering a long overdue correction of the over-valued USD. In the meantime, Eurozone growth continues to lag and badly needed structural reforms have once again taken a backseat in face of economic slowdown. We expect more of the same for EUR/USD this year, where it would probably benefit by default from a correction in the USD. We expect EUR/USD to trade largely in 1.00 – 1.06 range for Q1 2003 and ending the year around 1.10 assuming a benign war scenario in the Middle East (see US overview).

However, if the war in the Middle East were to progress badly, then risks are for a sharper euro appreciation. In that case, rising geopolitical tensions could see EUR/USD surge to 1.10 and poised to challenge levels beyond in short order sometime in Q1, upon which the ECB might be compelled for the first time since its inception to slow the rise in EUR via intervention or even monetary easing if necessary. 1.10 is also estimated to be European exporters' threshold for euro strength. Of course, if the war goes swimming well for the US and its allies then EUR/USD could see a knee-jerk pullback towards 1.00 on the dissipation of risk aversion though downside should be supported by underlying fundamental concerns of the US twin deficits. Downside for EUR/USD could also be supported on greater interest by global central banks to diversify further into euro in their reserve holdings now that euro has somewhat proven itself by not being a perennially depreciating currency. That Eurozone institutions such as ECB and the Stability and Growth Pact appear to have weathered the economic slowdown and protracted uncertainty also go some way to alleviate lingering doubts about the viability of the EMU project.

For 2003, assuming a quick and successful resolution to geopolitical tensions in the Middle East, we expect the Eurozone economy re-embark on the path of gradual recovery, with GDP growth expected to rise to 1.5% from an estimated 0.8% in 2002, albeit still below trend (estimated 2.0-2.5%). Growth is expected to be underpinned by a recovery in consumer spending which had been unusually depressed in 2002 despite relatively stable unemployment rates, due in part to perceptions of high inflation resulting from the changeover in euro notes and coins and geopolitical uncertainties. This suggests that there are prospects of pent-up consumer demand which could

Composition of real GDP growth in Eurozone

%q/q	Q3 2002	Q2 2002	Q1 2002	Q42001	Q32001
Real GDP	0.3	0.3	0.4	- 0.3	0.2
Domestic demand	0.3	0.2	0.1	- 0.3	- 0.3
Private consumption	0.5	0.2	- 0.2	0.0	0.1
Government consumption	0.3	0.8	0.9	0.4	0.4
Gross fixed capital formation	0.0	- 1.2	- 1.0	- 0.9	- 0.7
Changes in inventories	- 0.1	0.1	0.2	- 0.1	- 0.3
Net exports	0.1	0.1	0.4	0.0	0.4

Source: ECB



be unleashed upon the dissipation of geopolitical uncertainties. Capital spending is unlikely to be a drag on growth and could even stage a mild rebound in view of very low real rates in Eurozone currently and relatively firm rates of capacity utilization. Net trade could be a slight drag as imports rebound on the back of a gradual recovery in Eurozone domestic demand. Inflation is expected to ease to just shy of 2% assuming oil prices retreat from current USD30+ per barrel to low USD 20s per barrel and EUR/USD holds firm around current levels. Based on our central scenario, the ECB is likely to remain on hold for H1 2003. Fiscal policy is expected to turn mildly restrictive, as several large countries, notably Germany, struggle to compile with budget deficits limits in the Stability and Growth Pact.

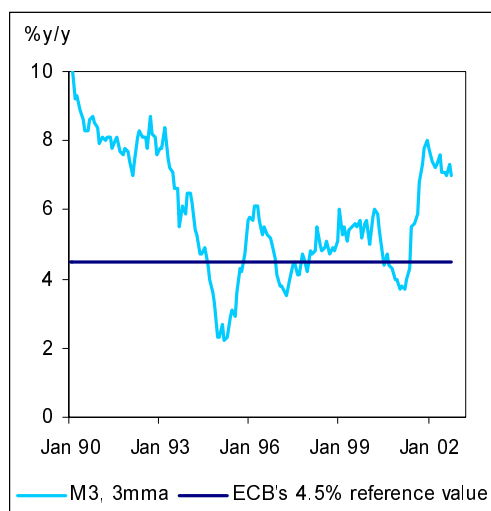
Main risks to our Eurozone growth outlook lies in a less than sanguine than expected outcome in the Iraqi situation than currently being discounted by markets. In that case, oil prices could surge further and sustain lofty levels for longer periods of time. Coupled with an expected plunge in confidence levels, the global economy is likely to slip back into a recession. Sustained higher oil price levels would push headline inflation higher and it could remain stubbornly above 2.5% well into 2004. Constrained by its 2% inflation target, the ECB is likely to hesitate cutting interest rates to cushion the negative growth impact of higher oil prices. This is particularly if inflationary expectations become entrenched at higher levels and workers ask for compensating wage increases. In this scenario, bond yields risk spiking higher too, adding further weight on growth.

ECB reviewing its monetary strategy...

ECB president Duisenberg indicated on 5 December that the ECB had decided to come up with 'a serious assessment and evaluation' of its two pillar monetary strategy' sometime in H1 2003. While he clarified that this assessment would not necessarily entail a change in strategy, emphasizing that the ECB is "still happy" with its strategy, speculation of a switch to a more symmetrical inflation target around 2% and/or higher inflation target has prompted some expectations of further easing from the ECB. This is especially after the ECB enacted a rather bold 50bps cut in key repo rates to 2.75% on 5 December in face of an above 2% headline inflation and with the ECB missing its 2% inflation target for the third year in a row in its 4-year history. Moreover, the ECB governing council clearly cited that "downside risks to economic growth have not vanished" for its decision, sounding a little more like the US Federal Reserve and giving greater weight to growth risks.

Basically, the ECB's monetary strategy consists of three main elements: a quantitative definition of price stability (represented by the 2% inflation target) and the two "pillars" used to achieve this objective. These two pillars are the M3 money supply growth reference value and a broadly based

Persistently above target M3 growth presents problem for ECB



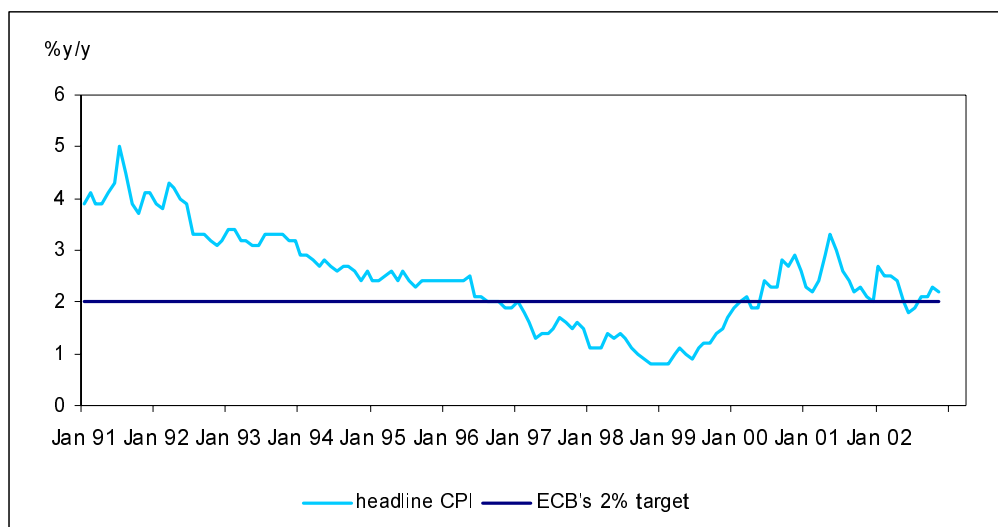
Source: Bloomberg

assessment of the outlook for price developments and risks to price stability in the euro area as a whole. M3 money supply has been criticized for not being a leading indicator for inflation, particularly in the last 2 years when sustained declines and volatility in global stock markets have seen investors seeking refuge in money market instruments and pushing M3 growth way above ECB's reference value of 4.5% on a sustained basis. This leads to "at least a communication problem with M3" in the words of ECB council member Quaden, particularly when the ECB decides to cut interest rates even when M3 growth is well above ECB's reference value of 4.5%. Thus, there is a possibility that M3 money supply growth reference value could be set back from its pillar status, being relegated to one of the many factors that the ECB evaluates in its assessment of the inflation outlook.



On the issue of price stability, the ECB has been criticized for the ambiguity of the lower bound of its 2% target and there had been some criticisms too about the 2% target being too low. ECB member Welteke indicated recently that the inflation target of 2% “may possibly be too ambitious”. On the former concern, ECB chief economist Issing has implied an inflation target range of 1-2% in recent months. While shifting to a symmetric target of 2.5% like the one used by the BoE could be appealing, changing the inflation target while the ECB has missed hitting the target in 3 out of the 4 years since its inception risks undermining ECB’s inflation fighting credentials. In the long-run, a weakening in ECB’s credibility as an inflation fighter could mean higher inflation premium in Eurozone bond yields and a weaker EUR.

Headline CPI mostly stayed above the 2% target since ECB's inception in 1998



Source: Bloomberg

At the current juncture, our best guess is that the ECB would not use a review of its strategy as basis for a change in interest rates.

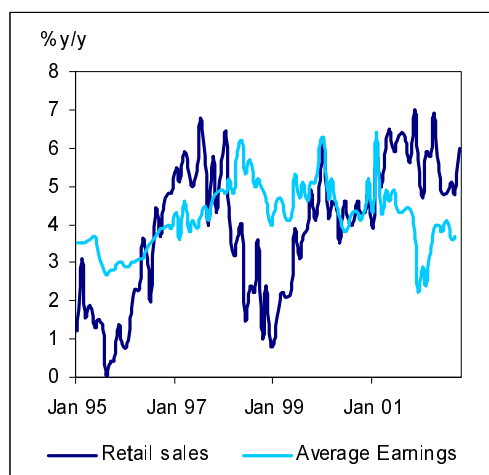
UNITED KINGDOM

The UK economy steered steadily through the global economic fog in 2002, giving rise to the resilience of the sterling pound last year. Though UK growth figures were unimpressive in the first half of 2002, growth recovered in the second half as domestic demand strengthened, defying expectations of a slowdown. The UK Consumer remained the key driver of the UK economy while exports continued to be a drag on growth. Evidence of strong consumer spending lie in strong retail growth, recovering consumer confidence and UK equities, buoyant mortgage lending and consumer credit. Low unemployment rates and steady wage increases were also supportive of buoyant spending. The housing sector also boomed, and soaring house prices restrained monetary policy accommodation despite the global slowdown. As such, despite the weak global environment, the BoE is expected to keep interest rates on hold till late H1-03. Bold public spending plans also supports the domestic economy, injecting further stimulus to drive economic growth. The UK economy had outperformed counterparts like the US and the European economies, giving rise to the strength in GBP. Volatility in the USD and uncertainty of a US economic recovery should also maintain investors' interest in GBP on the back of yield appeal and firm domestic fundamentals. Geopolitical uncertainty also raised GBP's safe haven allure on UK's net oil exporter status. However, UK's bulging trade deficit is likely to limit gains on GBP. As such, we revise up our forecast for GBP/USD to 1.5600-1.6200 in Q1-03. Anti-EUR sentiment had risen lately, though this had little impact on EUR/GBP - which rose above our trading band of 0.6200-0.6400 in Q4-02. Unless the UK government dismisses the case for UK entry into EMU (PM Blair had recently toned down his hawkish stance), EUR/GBP is likely to remain supported into H1-03. We look to trade EUR/GBP between 0.6400-0.6600 in Q1-03.

Growth momentum moderating

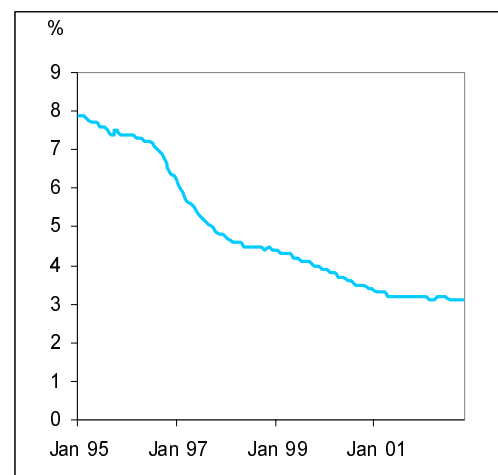
Undisputedly, the UK Consumer was the key driver of UK growth for 2002. Monthly retail sales have posted surprisingly strong increases in Q4-02, refuting calls for a slowdown in the consumer sector. However, incipient signs of weakness in the service sector seen in CBI distributive trades and PMI services indices have emerged and this could mean a moderation in private consumption in the coming months – though we must add that such indications have surfaced since the second half of 2002 and were proven otherwise. Still, retail spending continues to outpace wage growth and this could prove to be unsustainable. Consumers have also been financing their spend-

Consumer spending sustainable?



Source: Bloomberg

Unemployment at record lows

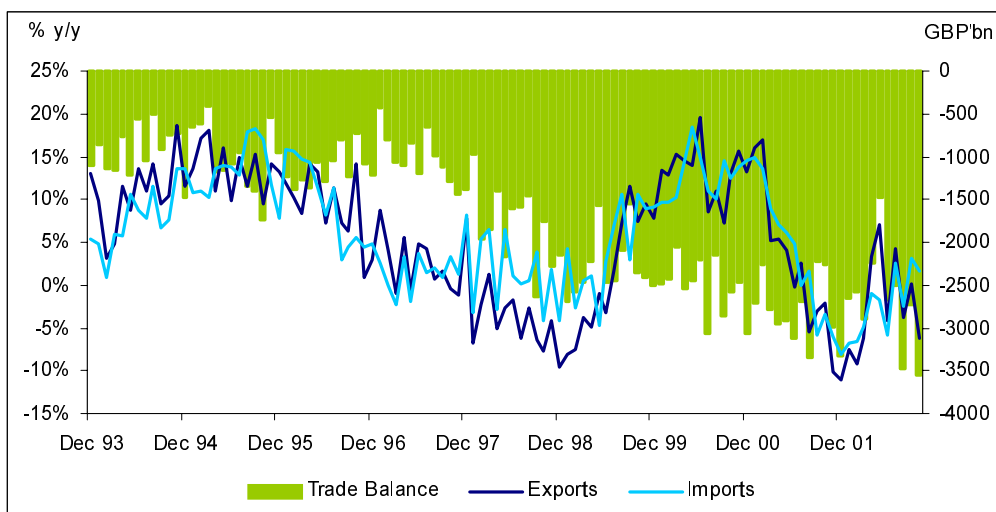




ing through increased borrowing against the inflated value of their houses that have risen on average by more than 30% this year, according to Halifax (UK's largest mortgage lender). Thus, there are fears that consumers could tighten their purchases should house prices retreat. As such, the strong consumer spending could experience some moderation into H1-03 though a sharp slowdown is not expected.

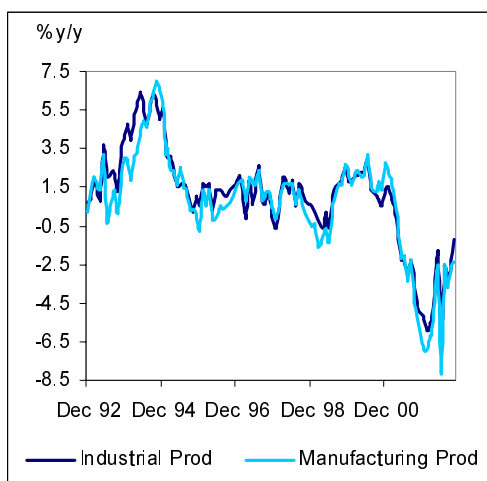
The moderation in domestic demand is likely to be compensated by a recovery in exports in H2-03, though that very much depends on a global recovery as well. For now, the trade deficit is clearly deepening into the Red as exports falter and imports remain strong - certainly a drag on growth.

Trade deficit at record highs



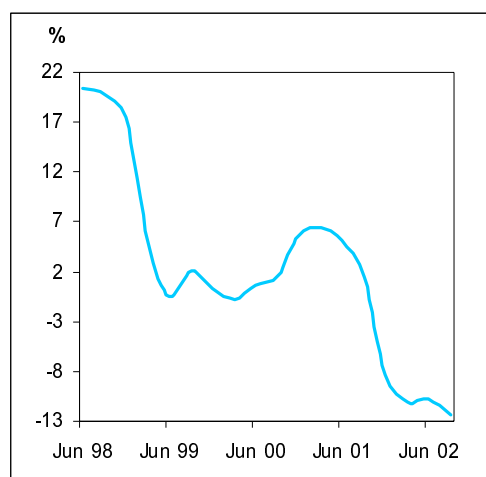
Source: Bloomberg

Manufacturing sector still in doldrums



Source: Bloomberg

Fall in Business investment



With lacklustre exports, it was unsurprising that industrial production continues to be weak throughout 2002. In recent months, monthly IP numbers have dipped into the negative territory, boding ill for the manufacturing sector. Forward-looking PMI and CBI surveys also show a lack of improvement in manufacturing activity. Other GDP components also pose a worry. Business investment registered a record decline in Q3, making up only 9.5% of GDP, below the trough of 9.8% in the 1990s recession. The decline in business investment was largely broad based, igniting fears of declining productivity and production going forward. However, with resilient domestic demand and renewed optimism in the global economic outlook, some recovery in business confidence



could trigger a rebound in business investment. The only sector outperforming was construction investment, though this was largely due to the housing boom. However, the housing sector could turn lower in 2003 should demand moderate in the coming months. Despite the risks ahead, the UK economy is expected to ride through 2003 in a rather plain-sailing manner (recall the government's pump-priming measures) and register at least 2.5% growth next year.

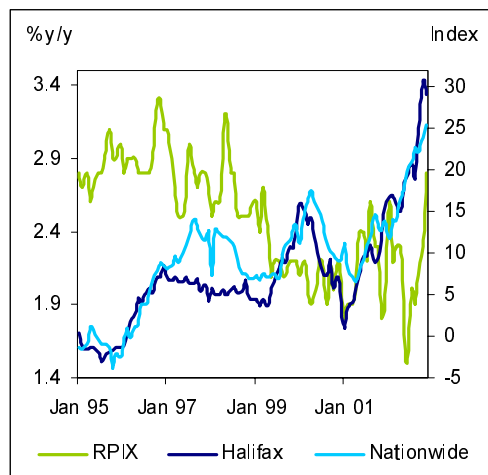
Policy implications

We expect policy measures to be supportive of domestic growth into 2003. On the fiscal front, downward revisions in the government's growth forecasts (1.6% for 2002 from 2.0-2.5%, and 2.5-3.0% for 2003 from 3.0-3.5%) have resulted in a shortfall in tax revenues. However, the government chose to increase borrowing in its Pre-Budget Report to fund intended pump-priming measures. In fact, government borrowing is projected to almost double from previous forecasts (refer to table). That said, Chancellor Brown also realigned the government's initial optimistic growth forecasts with conservative markets' expectations and this should keep the budget deficit intact into 2003. On the monetary front, the BoE is expected to maintain an easy and flexible stance, keeping interest rates on hold into H1-03. The tug-of-war between the weak global environment and booming housing market place the BoE on a tight rope to maintain a fine balancing act. A tilt in balance at any point could lead to speculation of BoE shifting either way as observed in past changes in expectations. But for now, inflation risks are evenly balanced with the RPIX expected to meet BoE's inflation target of 2.5% in 2 years, though only after rising above it for much of 2003.

UK government budget			
	2002/03	2003/04	2004/05
UK budget forecasts (previous forecast)			
Public borrowing (GBP bn)	20.1 (11.0)	24 (13.0)	19 (15.0)
Public borrowing (% of GDP)	1.9 (1.1)	2.2 (1.2)	1.6 (1.3)
Budget deficit (% of GDP)	1.2 (0.9)	1.5 (1.2)	1.3 (1.4)

Source: Bloomberg

Inflation to edge higher



Source: Bloomberg

BoE's dilemma

House prices have defied expectations and continued to soar buoyantly in the recent months. Latest figures by Nationwide showed that house prices rose at their annual highest rate in 13 years in November by 2.0% m/m and 25.0% y/y. The low interest rate environment and firm employment conditions have seen mortgage lending and consumer credit climb relentlessly higher as well. However, as employment conditions and wage growth are likely to taper off into H1-03, housing consumption could start to slow – though this might take a longer-than-expected period of time. Nevertheless, this could result in moderate price increases in house prices instead of current sharp rises. The Council of Mortgage Lenders projects annual price inflation to slow to 7% in 2003 from 23% in 2002. Though some BoE officials are optimistic that house prices are likely to slow in 2003, (giving them leeway to keep interest rates on hold till late H1-03), we do not rule out an earlier-than-expected rate hike if global recovery occurs

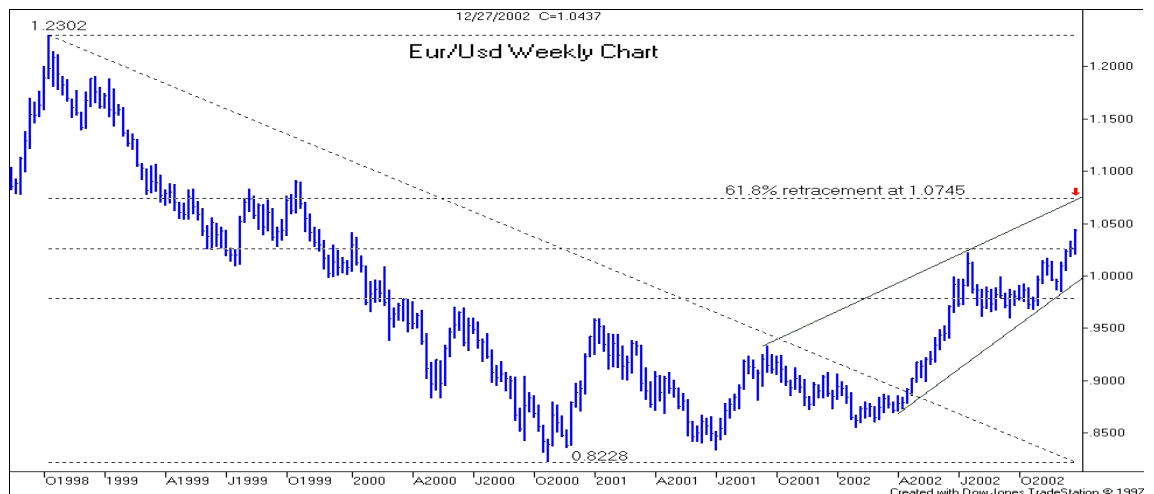


and house prices fail to retreat. In fact, from the graph, we observe that RPIX has closely tracked housing prices since mid-last year and with housing depreciation costs being the main contribution to the RPIX spike of 2.8% in November, BoE is likely to keep a close eye on housing prices. As such, a steady hand by BoE, despite rising price pressures, provides a form of monetary policy accommodation and is supportive of growth. The BoE projects inflation to rise above its target (of 2.5%) by year-end and remain over much of it in 2003 on the back of increased oil prices and high contribution from housing depreciation. However, inflation is expected to converge towards its target rate at the end of the 2-year forecast period.

TECHNICAL STRATEGY

TECHNICAL OUTLOOK FOR EUR/USD FOR QRT 1 2003 1.0420-30

The bullish view from last Qrt appears intact as we came close to the major resistant highlighted previously at 1.0480 (high of 1.0444 so far). While further gain is likely for the next few months, the next major resistant at 1.0740-50 will likely be difficult to overcome. This level represents the 61.8% retracement of the drop from 1.2302 (Oct98) to the low of 0.8228 (Oct00) as well as trend-line resist. Expect further gains for the first 1-2 months but 1.0740-50 will likely limit any further gain for a period of consolidation.



TECHNICAL OUTLOOK FOR USD/JPY FOR QRT 1 2003 119.85-95

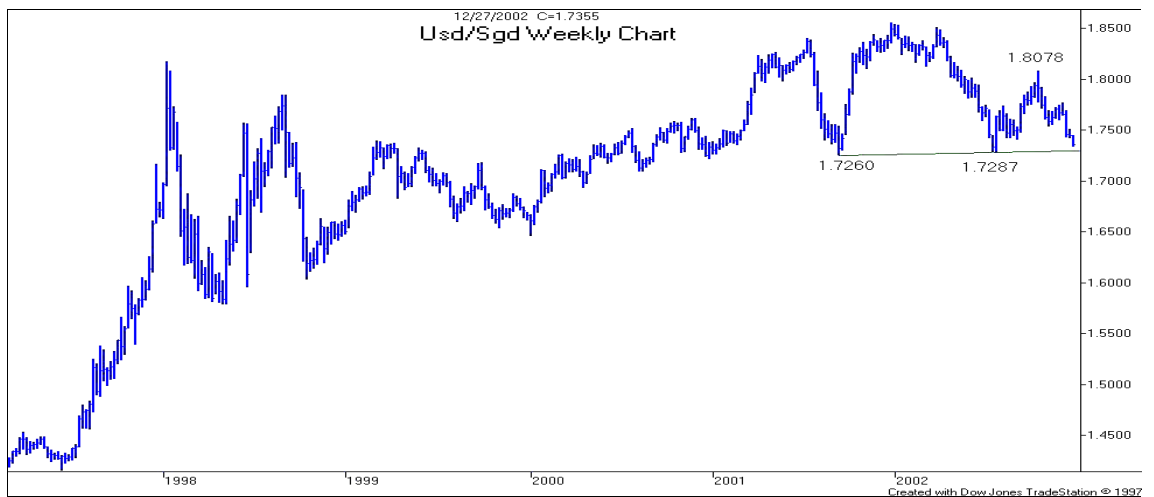
The rebound from the low of 115.50 ran into strong resistant at 125.65-75. Unless this resistant is taken out, further USD weakness is envisaged towards 115.50 again. However, 115.00-50 represents a major support and a clear breach appears unlikely at this juncture. In other words, the coming Qrt trading range will likely be limited to 115.00-126.00.





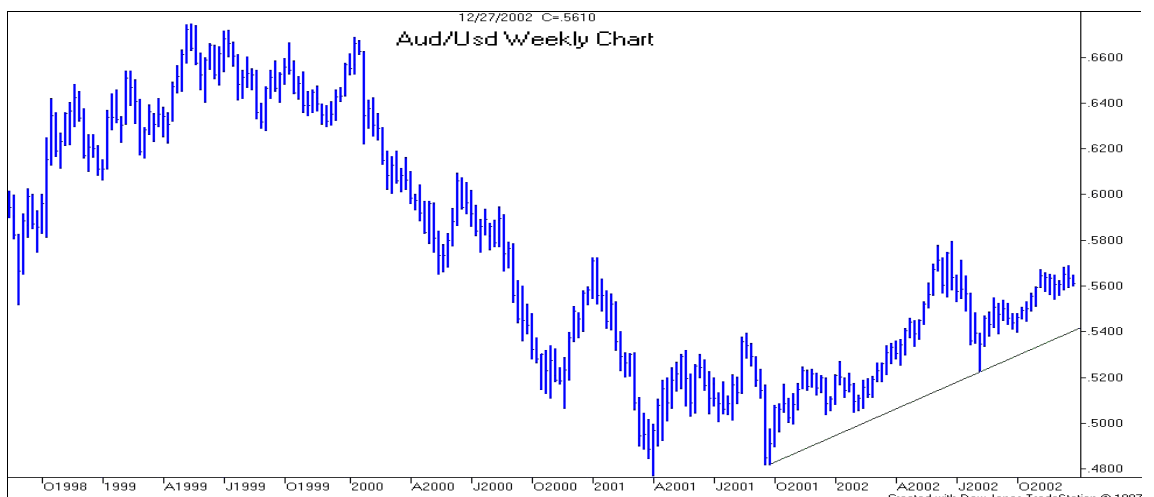
TECHNICAL OUTLOOK FOR USD/SGD FOR QRT 1 2003 1.7335-45

While the bullish target highlighted at 1.8070 was met with a high of 1.8078, the sharp drop from there does not bode well for the USD for the next Quarter. Any breach of the critical support at 1.7260-80 will likely trigger further loss towards 1.7050. Only a move above 1.7600 will stabilize the USD now.



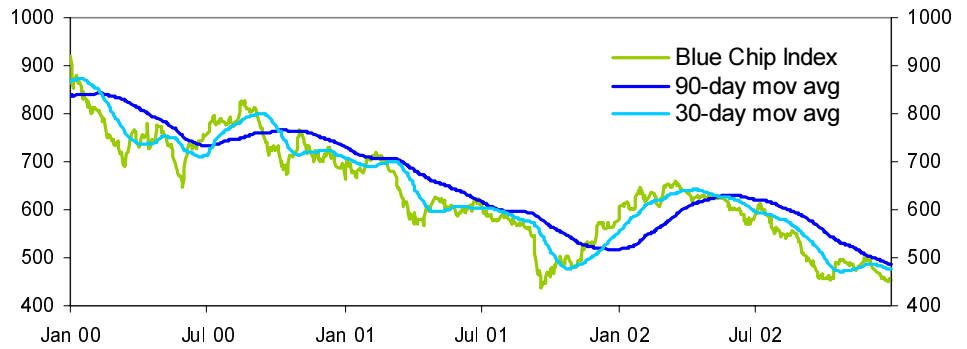
TECHNICAL OUTLOOK FOR AUD/USD FOR QRT 1 2003 0.5620-30

The AUD traded in a narrow range of 0.5405-0.5690 for the past 3 months. With most indicators still showing neutral readings, further range trading is likely for the next few months. Expect range trading between 0.5400 and 0.5800.



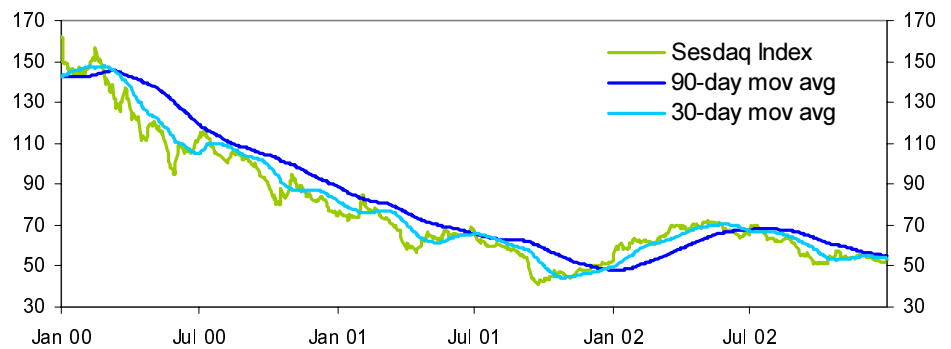


UOB BLUE CHIP INDEX



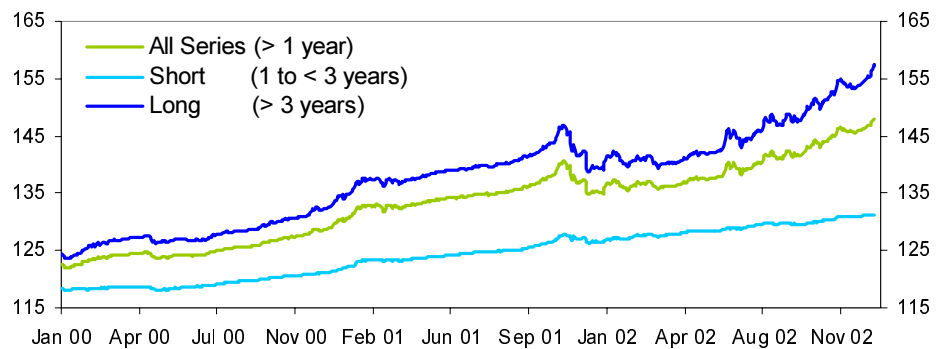
<i>Last</i>	455.65	<i>on 31 Dec 02</i>
<i>2002 High</i>	658.85	<i>on 19 Mar 02</i>
<i>2002 Low</i>	451.07	<i>on 26 Dec 02</i>
<i>Record High</i>	1126.36	<i>on 04 Jan 94</i>
<i>Record Low</i>	99.97	<i>on 08 Oct 75</i>

UOB SESDAQ INDEX



<i>Last</i>	52.56	<i>on 31 Dec 02</i>
<i>2002 High</i>	72.26	<i>on 08 May 02</i>
<i>2002 Low</i>	51.06	<i>on 10 Oct 02</i>
<i>Record High</i>	203.60	<i>on 02 Jul 99</i>
<i>Record Low</i>	34.11	<i>on 08 Dec 87</i>

UOB SGS INDEX





UOB Banking Group Principal Offices

UNITED OVERSEAS BANK LIMITED

80 Raffles Place, #01-00
United Overseas Bank Plaza
Singapore 048624
Tel : (65) 5339898
Telex : RS 21539/21804 TYEHUA
Cable : TYEHUABANK
Fax : (65) 5342334

AUSTRALIA

UOB Sydney Branch
United Overseas Bank Building
Level 9, 32 Martin Place
Sydney N.S.W.2000
Australia
Tel : (61) 2-92211924
Fax : (61) 2-9221 1541

BRUNEI

Kuala Belait Branch
Ground Floor
Chinese Chamber of Commerce Bldg
Lot 104, Jln Bunga Raya
Kuala Belait, KA1131
Negara Brunei Darussalam
Tel : 673 3-331889/341012/342126
Fax : 673 3-331391

Bandar Seri Begawan Branch

Unit G5, RBA Plaza, Jln Sultan
Bandar Seri Begawan BS98811
Tel : 673 2-225477 / 222210 / 220380
Fax : 673 2-240792

CANADA

United Overseas Bank (Canada)
Suite 310, Vancouver Centre
P.O. Box 11616,
650 West Georgia Street
Vancouver, B.C., Canada, V6B 4N9
Tel : (1-604) 6627055
Fax : (1-604) 6623356

JAPAN

UOB Tokyo Branch
Shin Kokusai Building, 3-4-1,
Marunouchi
Chiyoda-ku, Tokyo 100, Japan
Tel : (81) 3-32164251
Telex : J22178 TYEHUA J
Cable : TYEHUABANK
Fax : (81) 3-32164254

UOB HONG KONG

Central Branch
5/F Floor Edinburgh Tower
15 Queen's Road Central
Hong Kong
Tel : (852) 2521 1521/2526 3875
Telex : 74581 TYHUA HX
Fax : (852) 2810 5506

Mongkok Branch

794 Nathan Road
Ground Floor, Kowloon
Tel : (852) 23812292
Fax : (852) 23974564

Landmark Branch

Gloucester Tower, The Landmark
Suite 2504-2506, 25th Floor
11 Pedder Street, Central
Tel : (852) 25326888
Fax : (852) 28684598

Bonham Strand Branch

38-40 Bonham Strand West
Hong Kong
Tel : (852) 2381 2292
Fax : (852) 2397 4564

PEOPLE'S REPUBLIC OF CHINA

UOB Beijing Representative Office
2513,
China World Trade Centre Tower 2
No. 1 Jian Guo Men Wai Avenue
Beijing, 100004,
People's Republic of China
Tel : (86) 10 - 6505 1863
Fax : (86)10 - 6505 1862

Chengdu Representative Office

Room 405, Holiday Inn Crowne Plaza
31 Zong Fu Street, Chengdu, Sichuan
P R C 610016
Tel : (86) 28 8674-8618 / 8674-8628
Fax : (86) 28 8674-8638

Shanghai Branch

2201 Jin Mao Tower
88 Century Boulevard
Pudong New Area, Shanghai 200121
The People's Republic of China
Tel : 86(21) 5047 3688
Telex : 33170 UOB SH CN
Fax : 86(21) 5047 9978

Shenzhen Branch

Room 305, 3rd Floor
Century Plaza Hotel
Kin Chit Road, Shenzhen
The People's Republic of China
Postal Code 518001
Tel : (86) 755-8232 2755
Telex : 420385 OUB SZ CN
Fax : (86) 755-8234 3512

Xiamen Branch

19 Hubin Bei Road
United Overseas Bank Building
#01-01, Xiamen 361012
People's Republic of China
Tel : (86) 592-5081601/4
Telex : 93079 UOB XM CN
Cable : 1230
Fax : (86) 592-5081605

Guangzhou Branch

Unit 205 Guangzhou Aether Square
986 Jie Fang Bei Road
Guangzhou, Guangdong Province
People's Republic of China
Postal Code 510030
Tel : (86) 20 8667 6029
Telex : 44931 UOB GZ CN
Fax : (86) 20 8667 0779

SOUTH KOREA

UOB Seoul Branch
Suite 1508/9, Kyobo Building 1,
1-Ka, Chongro
Chongro-Ku, Seoul 110-714
CPO Box 929, South Korea
Tel : (82-2) 7393916/9
Telex : K 28978 TYEHUA
Fax : (82-2) 7309570

MALAYSIA

United Overseas Bank (Malaysia) Bhd
Menara UOB
Jalan Raja Laut, P O Box 11212
50738 Kuala Lumpur, Malaysia
Tel : (60) 03-2924511
Telex : MA 31877 UOBMHO
Fax : (60) 03-2940617

VIETNAM

UOB Ho Chi Minh City Branch
Central Plaza Office Building
Ground Floor
17 Le Duan Street, District 1
Ho Chi Minh City, Vietnam
Tel : (84) 8-825 1424
Fax : (84) 8-825 1423
Telex : 813221 UOBHCM VT

INDONESIA

P T Bank UOB Indonesia
Menara BCD, 1st-3rd Floor
Jalan Jenderal Sudirman Kav 26
Jakarta 12920, Indonesia
Tel : (6221) 2506330
Fax : (6221) 2506331

THAILAND

UOB Bangkok Representative Office
Unit C-6, 2nd Floor
C.P. Tower Building
313, Silom Road, Bangrak
Bangkok 10500, Thailand
Tel : (66) 2382216/7/8
Fax : (66) 2382219

UOB Bangkok International Banking Facility

UOB Radanasin Building
10th Floor,
690 Sukhumvit Road, Klong-ton
Klong-toey, Bangkok 10110 Thailand
Tel : (662) 259-6220/21
Fax : (662) 259-4470

UOB Radanasin Bank Building

690 Sukhumvit Road
Klongton, Klongtoey
Bangkok 10110
Tel : (662) 260-0090
Fax : (662) 260-5310/1
Telex : 20820 UOB RTH
SWIFT : RSBXTHBK

UNITED STATES OF AMERICA

UOB Los Angeles Agency
911 Wilshire Boulevard
Ground Floor, Los Angeles
California 90017-3478, USA
Tel : (1-213) 6238042/6
Telex : 6831011 TYHUA
Cable : TYEHUABANK LOS ANGELES
Fax : (1-213) 6233412

UOB New York Agency

UOB Building
592, 5th Ave,
10th floor, 48th Street
New York, NY 10036
Tel : (1) 212-382 0088
Fax : (1) 212-382 1881

UNITED KINGDOM

UOB London Branch
19 Great Winchester Street
London EC2N 2BH, United Kingdom
Tel : (44-207) 628 3504
Telex : 8954292 TYEHUA G
Cable : TYEHUABANK
Fax : (44-207) 628 3433

TAIWAN

Taipei Branch
10th Floor, Union Enterprise Plaza
109 Minsheng East Road
Section 3 Taipei 105
Taiwan
Republic of China
Tel : (886-2) 2715 0125
Fax : (886-2) 2713 7456

PHILIPPINES

UOB Philippines, Pacific Star Building
17th Floor, Sen. Gil Puyat corner
Makati Avenue Makati City, Philippines
Tel : 632 8788686
Fax : 632 8115917

MYANMAR

UOB Yangon Representative Office
48 Aung Teza Street, 6th Ward
High Land Ave
Mayangone Township
Yangon
Tel : (95) 1 667818
Fax : (95) 1 544 126