

**Asia Economics – Limited Re-coupling Ahead**

- **External environment likely to deteriorate in 2008:** The risk of credit problems attacking the heart of US growth - household consumption - has increased significantly. Morgan Stanley's US Economics team expects recession in 2008.
- **Limited re-coupling in 2008:** We believe that AXJ will face the real test during the first quarter of 2008 as the US dips into recession. We believe that the market may first be surprised on the downside as the growth trend slows in AXJ in 2008 (limited re-coupling) before it builds the conviction for soft decoupling.
- **AXJ better placed to face US recession:** The macro balance sheet is much less vulnerable to external shocks in the current cycle than was the case in 2001. Domestic demand dynamics are also much better in the current cycle.
- **Downside risk:** Deeper recession in US causing severe global financial risk aversion.

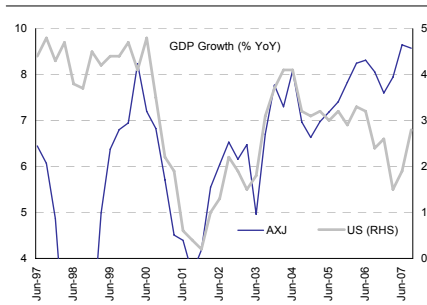
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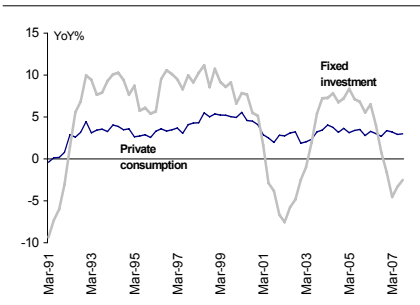
**Asia: Limited Re-coupling Ahead**

**Real Test Is Yet To Come?**



Source: CEIC, Morgan Stanley Research

**US Consumer Steady So Far**



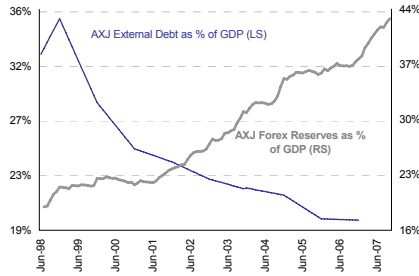
Source: CEIC, Morgan Stanley Research

**AXJ sustaining strong growth so far:** Despite a slowdown in the US over the past few quarters, AXJ has maintained its strong growth trend until recently. AXJ growth remained close to its highest levels seen post Asian crisis during 3Q07, at 9.0%.

**Real test is yet to come?:** Consumer demand from developed countries has been supporting growth for export-oriented Asia. However, slower job growth, tightening lending standards, mortgage rate resets and high energy & food prices are now testing the resilience of the US consumer.

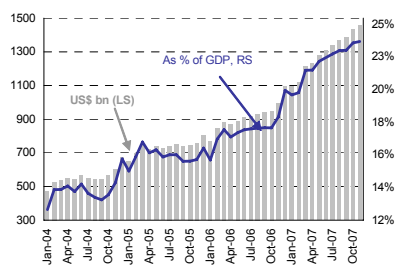
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AXJ Balance Sheet is Strong



Source: CEIC, IMF, Morgan Stanley Research

AXJ Stock of Sterilized Excess Liquidity



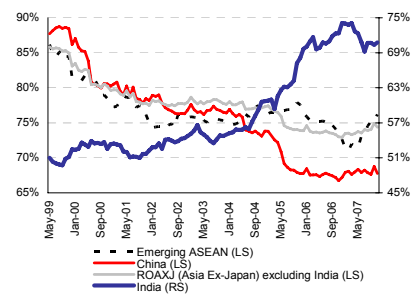
Notes: 1) Sterilized excess liquidity is defined as the inflows of forex reserves sterilized by issue of short term paper and cash reserve ratio hikes. 2) The above includes data for Indonesia, Philippines, India, China, Taiwan, Malaysia, Thailand and Korea. Source: CEIC, various central bank websites, Morgan Stanley Research

**AXJ's balance sheet is in very different shape** now than it was in 1997-1998, as evident in the trend on FX reserves and external debt. While external debt to GDP has declined to 19.8% as of 4Q06 from 33.7% in 1Q99, foreign exchange reserves to GDP has increased to 42.8% as of Oct-07 (US\$2.8 trillion) from 22% in 1Q99.

**AXJ's surplus liquidity stock** (stock of liquidity sterilized through issuance of bonds and cash reserve ratio hikes) has increased to about US\$1,455 bn (23.5% of GDP) as of November 2007 from US\$600 bn (14.4% of GDP) in November 2004.

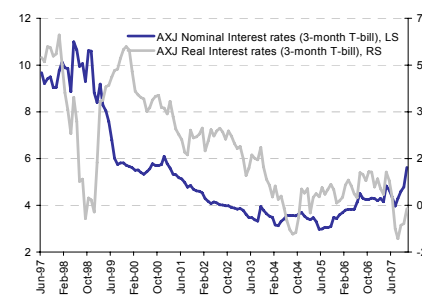
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Bank Credit Deposit Ratio



Source: CEIC, Morgan Stanley Research

Real Interest Rates (Using CPI Inflation)

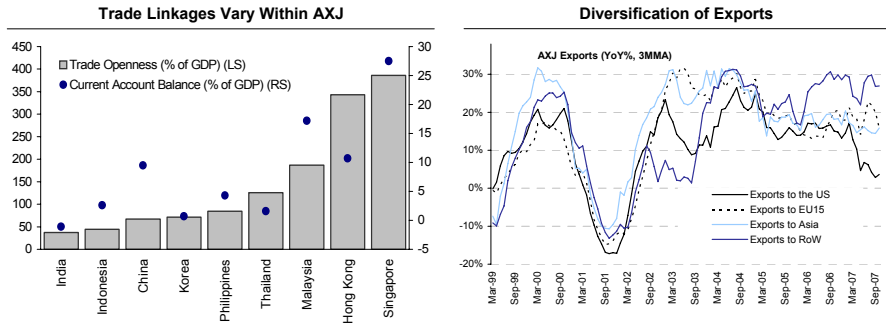


Source: CEIC, IMF, Morgan Stanley Research

**Financial Leveraging Manageable:** The region has not had any excesses in terms of overall leveraging trend post Asian crisis. This excess liquidity merely reflects relatively weak credit cycle, implying that the financial leveraging in the real economy is also manageable in this cycle. Most countries in the region have now cleared up the banking sector nonperforming loans (NPLs). Except for India, most of the countries in the region have seen a steady decline in their credit-deposit ratio to 74.4% as of Nov-07 compared with 85% in Nov-99.

**Monetary policy accommodative:** Current interest rate levels in AXJ are relatively stimulative, in our view.

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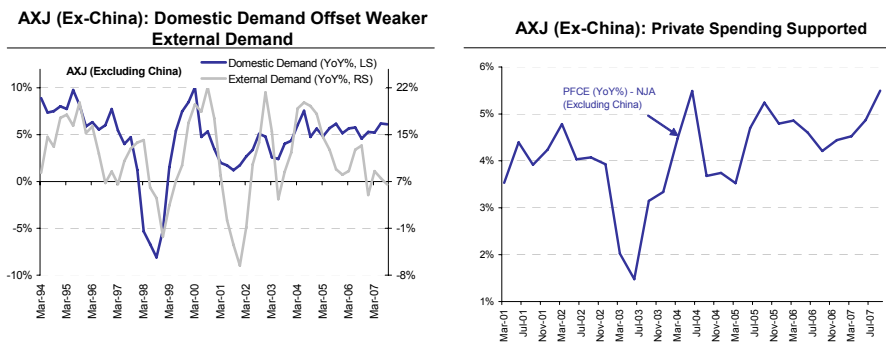
Source: CEIC, Morgan Stanley Research

Source: CEIC, Morgan Stanley Research

**Trade Linkages Spillovers from tightening financial conditions in US and Europe:** The slowdown in the developed world would affect AXJ through trade linkages.

**Trade Diversification to Help?** External slowdown may not be as severe because in the rest of the world (excluding US and Europe) export growth is not likely to collapse. Indeed, while growth in AXJ exports to the US has slowed sharply, to 3.6% YoY on three month average basis in October 2007 (from 13.2% YoY in 4Q06), exports to Asia and the rest of the world (excluding US, Europe and Asia) have remained relatively stable, up 16% and 19.2% respectively (versus 16.7% and 20% growth in 4Q06). While we expect a further slowdown in external demand as the US growth trend deteriorates, the downside may not be as severe as witnessed in 2001 with support from rest of the world.

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Source: CEIC, IMF, Morgan Stanley Research

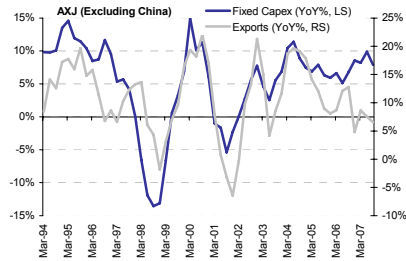
Source: CEIC, IMF, Morgan Stanley Research

**Domestic demand growth should hold up well in the current cycle.** All three components of domestic demand – private consumption, investments, and government spending – are likely to fare better in 2007 than in 2001.

**Private consumption growth has been relatively strong in the current cycle,** even as external demand is slowing. Indeed, private consumption for the AXJ (ex-China) has accelerated to a 30-quarter high of 5.5% in 3Q07.

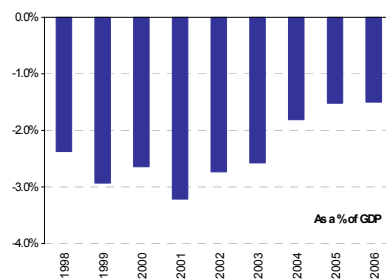
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AXJ (Ex-China): Fixed Capex Not Correlated with Exports Like Previous Cycles



Source: CEIC, IMF, Morgan Stanley Research

AXJ: Low Deficit Should Allow A Fiscal Policy Response, if Needed



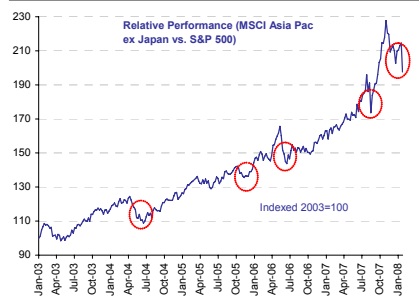
Source: CEIC, CMIE, Morgan Stanley Research

**Capital expenditure trend is decoupling from exports.** In the past, AXJ capex was highly correlated with exports, and capex was the only driver of domestic demand. In the current cycle, capex growth will not decelerate as sharply due to demand for investments to feed improved private consumption growth and construction/infrastructure needs.

**Fiscal policy has enough room to respond to a sharp external slowdown.** Public debt to GDP for the region has also declined significantly from post-crisis highs. The fiscal deficit was just 1.5% of GDP in 2006, versus the peak of 3.2% in 2001. In the event of a sharper external slowdown, governments will likely increase public spending.

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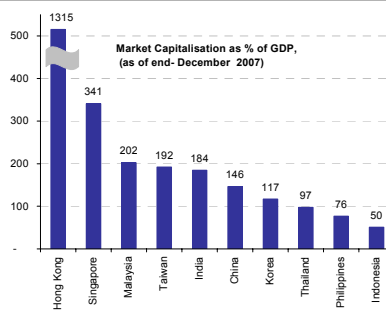
High Beta Markets



Source: Factset, Morgan Stanley Research

Circles denote periods of risk aversion

Asset-Market Related Economies?



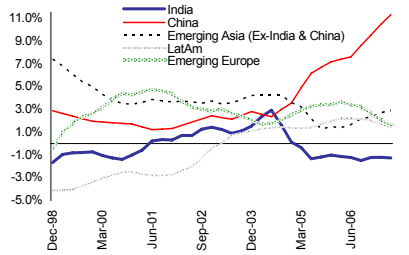
Source: Bloomberg, Morgan Stanley Research

**Key risk - financial markets linkages are high:** A US recession would lead to risk reduction in financial markets, in our view. Though AXJ asset markets have been generally outperforming the US market in the past few years, it has also consistently underperformed during periods of risk reduction.

**Double whammy:** Not only would a US recession have trade linkages spillover, the financial markets spillover would also impact consumer & business sentiment and affect asset-market related activities and the availability of risk capital.

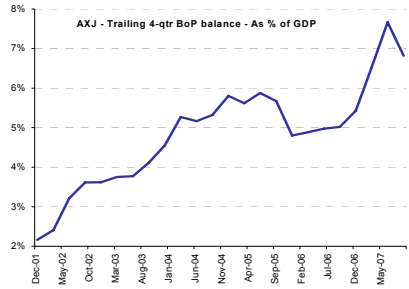
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**Trailing Four-Quarter Current Account Balance  
(As a Percentage of GDP)**



Note: Based on MSCI Emerging Market universe filtered by countries with nominal GDP greater than US\$100 bn. 1. Includes Korea, Taiwan, Indonesia, Thailand and Malaysia. 2. Includes Argentina, Brazil, Mexico and Venezuela. 3. Includes Russia, Turkey, South Africa, Israel, Czech Republic. Source: CEIC, central bank websites, Morgan Stanley Research

**Trailing Four-Quarter Overall BOP Balance  
(As a Percentage of GDP)**



Source: CEIC, IMF, Morgan Stanley Research

**Who is least exposed?:** In our view, China, Malaysia, Singapore, with a large current account surplus remains the least exposed to a potential reversal in global risk appetite. A reversal in the latter would weigh on less stable portfolio equity and debt flows.

**Who is most exposed?:** We think that India, Indonesia, and Philippines with a low current account balance, is the most vulnerable to a potential risk aversion in global capital markets amongst the AXJ markets. Infact, the most important differentiation between India and Rest of Non-Japan Asia (ROAXJ) is that while India runs a current account deficit, ROAXJ runs a current account surplus.

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