

# Asia Pacific economic outlook



## Outlook for Select Asia Pacific Economies

### Australia

In another signal that the Asia Pacific region is coming out of the global recession much more strongly than the rest of the world, defying muted forecasts earlier, the Australian economy accelerated to register 0.6 percent growth in the quarter ending June 30. The reasons for the acceleration are the same as in most other countries of the region: rising consumer spending due to low interest rates and fiscal stimulus, coupled with growing exports to China. Consumer spending rose 0.8 percent while exports grew 1 percent.

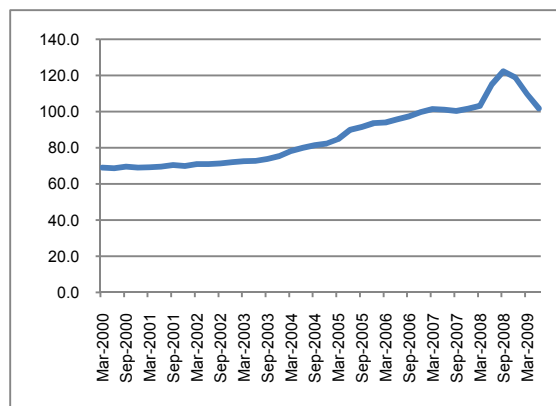
In the past decade, especially since 2004, one of the factors supporting higher export earnings, and therefore growth, was the increase in terms of trade as export prices increased at a faster pace than import prices. This allowed the mining sector to keep investment spending high. Starting in the last quarter of 2008, however, the terms of trade decreased. The strong demand for commodities by China kept export volumes relatively high and prevented what could have been a sharper decrease in export earnings. Net exports (exports minus imports) contributed to growth in the first quarter, but made a negative contribution of around 0.3 percentage points in the second quarter as imports jumped up.

Another factor that had kept the economy buoyant in recent years is the heavy borrowing by households to invest in housing. Households, highly leveraged, were expected to cut back consumption spending consequent to the global financial crisis as they had invested in illiquid assets that were declining in value. Government cash handouts to households of A\$20 billion and the sharp reduction in

interest rates helped sustain both domestic consumption and demand for housing. Falling inflation and resilient employment kept household purchasing power high. Demand for new homes surged between October 2008 and June 2009 as government offered a grant of A\$21,000 to first-time buyers.

Looking ahead, Australia, the only advanced economy to avoid slipping into a recession, is likely to remain resilient, spurred by domestic consumption. Business investment, expected to act as a drag on growth, grew 1.9 percent in the second quarter after declining 6.2 percent in the first quarter. In August, both consumer and business confidence were high. While business confidence reached its highest levels in the last six years, manufacturing registered positive growth for the first time in 14 months.

### Terms of Trade Index, Seasonally Adjusted



Source: Australian Bureau of Statistics

The growth drivers, however, are likely to differ from those that had led the boom in the past decade. Net exports will likely act as drag on growth this year as demand for commodities remains subdued and imports are likely to surge to replenish inventory. Housing too will see some contraction as interest rates begin to rise and government starts reducing grants to first-time buyers. It is expected that the Reserve Bank of Australia (RBA) will start

raising the cash rate — at a 49-year low of 3 percent — from November, as it expects inflation to become a bigger concern than growth. The positive stimulus will come from the A\$22 billion program to invest in infrastructure (roads, rails, ports, hospitals, and schools), which will likely increase demand for machinery and equipment, and domestic household consumption. The single biggest risk factor is a sharp rise in unemployment, which reached 5.8 percent in July. So far unemployment has been less severe than expected, helping boost consumer confidence and spending. If the jobless rate were to rise, it could put a wrench in the works.

The Australian economy has avoided the worst so far, and indications are that it will continue to do so. RBA scrapped its earlier forecast of a contraction this year and expects the economy to grow by around 0.5 percent. The economy will likely register positive growth this year, and an acceleration next year, before it returns to its trend growth rate of around 3.5 percent in 2011.

## India

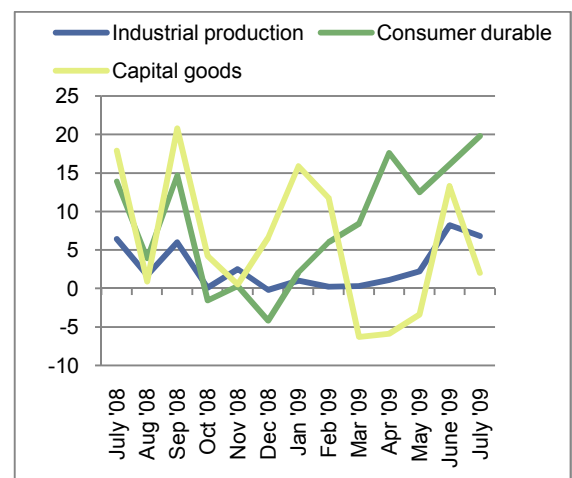
Between April and June, the economy grew at 6.1 percent, better than in the previous two quarters, and much better than was predicted by many in early 2009. In June, most predictions were up, including those from the IMF and the Reserve Bank of India, buoyed by increased industrial production in May and June. Since then, a number of factors have intervened to reduce growth forecasts, primarily the drought that hit after a gap of seven years.

Though the impact of the weak monsoon on growth is still uncertain, economists have shaved off 0.5 to 1 percentage point from their growth forecasts. The Department of Agriculture and Cooperation predicts a 10–15 percent decline in output of food grains. A bumper cotton crop and the big hike in minimum

support price (price at which farmers can sell to government agencies), will likely help overcome the decline in food grain production to some extent.

Despite the deficient summer monsoon, the economy may still grow at close to or above 6 percent. Services have so far managed to grow at a healthy pace, though some sub-sectors such as hospitality faced some difficulties — and are expected to continue to do so. A heartening feature is the much improved industrial performance of 8.2 percent in June and 6.8 percent in July. The consumer durables sector grew a whopping 19.8 percent in June, a sign that the worst may be over.

## Industrial Growth in Recent Months



Source: Bloomberg

The real question is whether industrial growth will be sustained to offset the expected decline in agriculture. The recent experiences with drought (in FY2003 and FY1988) give reasons to remain optimistic. In each of these years, industrial growth remained unaffected by the drought. It is expected that the urban demand will pick up due to the fiscal stimulus, hike in wages of government employees, and increased investment in infrastructure. Rural demand will likely not dip because non-farm activities contribute nearly half of the rural income. The

National Rural Employment Guarantee Scheme (a massive government program that promises 100 days of unskilled manual employment to every household), will help. Further, there are signs of a revival in exports and foreign direct investment (FDI) surged to \$3.5 billion in July, a 56 percent rise over the same month last year.

Better than expected advance tax collections in September have raised hopes of an early recovery. The finance minister, expecting a recovery in the January–March 2010 quarter, has stated that the government is likely to initiate the exit strategy in the next fiscal year. The RBI, however, appears to be caught between the proverbial rock and a hard place. After remaining in the negative zone for the past three months, the Wholesale Price Index slid into positive territory in the week ending September 5, forcing the RBI to raise its inflation forecast for the year from 4 percent to 5 percent. It is likely to be raised further to 6 percent. Inflation is mainly being driven by rising food prices. Monetary tightening to tackle food price inflation could threaten the nascent industrial sector recovery, but the RBI cannot ignore inflation for too long. The RBI governor has stated that India will likely be one of the first countries to reverse its monetary stimulus, though he does not want to raise interest rates sharply. This means that the reversal is likely to come in stages.

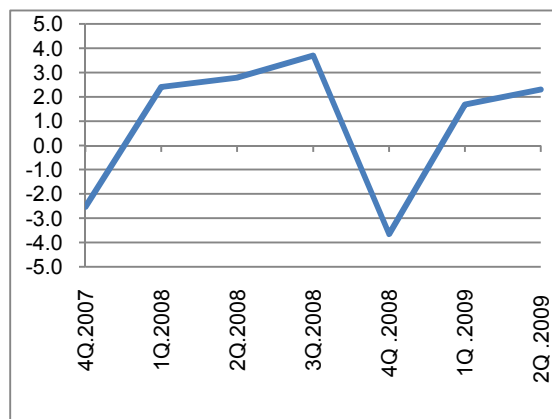
Overall, the economy seems to be on the path to recovery, unless a sharp reversal in fiscal and monetary stimulus threatens the nascent industrial sector recovery. The next financial year promises to be much better, helped by a lower base this year.

## Indonesia

Most indicators point to an improved macro environment and stronger growth in the coming months. To begin with, the political environment looks stable with the

resounding victory of President Susilo Bambang Yudhoyono in July. It will likely give a boost to his reformist agenda, though he may be obliged to follow a consensual legislative agenda as he would need support from other political parties to pass legislations. Meanwhile, the economy grew 2.3 percent (QoQ) in the second quarter, or 4 percent YoY. Manufacturing, after having declined in the previous two quarters, registered positive growth, while utilities, transport and communication, and services accelerated sharply. Government spending, which grew by nearly 24 percent over the previous quarter, made up for the mere 0.2 percent growth in private consumption.

### Real GDP Growth Rate (QoQ)



Source: Bloomberg

The expansionary fiscal policy and the cut in policy rates by 300 basis points to 6.5 percent helped the economy expand by 4.2 percent in the first half of the year, one of the highest in the Asia Pacific region (if we exclude China and India). Given the benign inflationary environment, Bank Indonesia (BI) has kept the interest rate unchanged in September and is likely to persist with it till the end of the year. Both core inflation (excluding food and energy) and consumer price inflation have been declining steadily since January. Public debt stood at a comfortable level of around 35 percent of GDP in 2008, and therefore, the fiscal deficit of 2.5 percent

envisaged in the budget is not a source of worry. Given the healthy corporate and household balance sheets, and with the deficit expected to narrow next year, the economy looks to be in good shape.

One significant area of concern was the difficulty businesses faced in obtaining capital, resulting in investment plans being either postponed or shelved. Prior to the global financial crisis, businesses obtained nearly half their investment capital from western investors. Banking system liquidity in Indonesia was relatively tight as loan growth outstripped deposit growth and domestic banks were hesitant to reduce their risk premiums, which meant that the decline in lending rates has not been as sharp as the cut in policy rates. It is, however, likely that domestic banks will reduce their lending rates in the coming months, and the liquidity situation will be comfortable given that demand for credit is not likely to rise sharply.

The key to economic stability at this point lies in exchange rate stability. If the rupiah were to collapse, as it did in October and November last year, it could result in higher inflation, forcing the BI to raise interest rates. It could also undermine global investor interest in Indonesian assets, accentuating the instability. It appears unlikely, however, that the exchange rate will plummet again. The rupiah will likely trade in the range of 10,000–11,000 to a US dollar by the end of the year, and will likely appreciate slightly next year. Exporters, however, will continue to feel the pinch of the global slowdown in the near term. Though exports in August were higher than the previous month by nearly 9 percent, they were still down 15.4 percent YoY. The resilience of the Indonesian economy, however, comes from the fact that unlike other major Asian economies it is not dependent on exports for growth.

The economy appears poised for an acceleration in growth. Rising consumer

confidence and the commitment by a number of domestic banks to lower deposit and lending rates will likely translate into higher private consumption expenditures. This, in turn, will impact business investment positively. Exports too may outperform earlier growth forecasts if the global economy revives sharply in the next quarter. If conditions remain favorable, growth may inch closer to 5 percent.

## Japan

The initial estimate of 0.9 percent growth in the second quarter was revised downward to 0.6 percent, which translates to an annualized growth of 2.3 percent. The downgrade was mainly on account of a fall in inventories as companies reduced their stockpiles of unsold goods. This is not necessarily bad news. It means that from here on the operating condition of businesses could improve.

The purchasing managers index (PMI) rose to 50.4 in July and further to 53.6 in August, the highest level in the last three years, which suggests continued expansion in the near term. Industrial production had accelerated in the April–June quarter, and inventory restocking is expected to continue to fuel growth till the end of this year. Machinery orders, however, declined in July and core private sector machinery orders are at their lowest levels since 1987, suggesting that business investment is not picking up. One factor that would be playing in the minds of businesses is the uncertainty centering on the policies the Democratic Party of Japan (DPJ) is likely to adopt and the impact these will have in the medium and long term.

The DPJ has indicated that it will try to boost domestic consumption through reduction in taxes and fees and provision of a social safety net. Skeptics, however, are worried that households may divert the increased income to savings rather than

increase consumption. If household spending does increase, it may turn out to be exactly what the doctor ordered. A big worry, however, is how the DPJ is likely to fund these policy measures. The DPJ plans to raise the money by eliminating waste in government and reevaluating public works projects, but what if these steps are not enough to raise the required resources? For instance, Prime Minister Yukio Hatoyama expects that the plan to provide child care, eliminate highway tolls and tuition fees, and increase unemployment benefits will cost the government around ¥7 trillion. It is doubtful that the government can generate as much by cutting “waste.” Will the government increase borrowings, ignoring a gross debt-to-GDP ratio of more than 180 percent, or will it increase taxes? Given that the DPJ has promised to reduce the tax rate for small businesses and not to increase the consumption tax for the next four years, big businesses are worried that the government may eventually end up increasing tax rates for them.

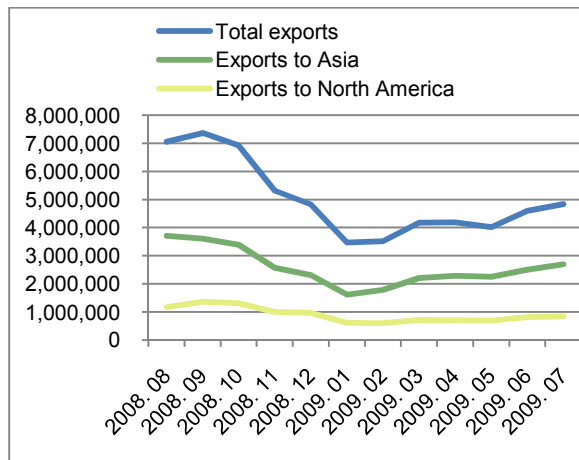
The promise to hike minimum wages by nearly 60 percent, reverse the policy to hire temporary workers and reduce carbon emissions, if implemented, is likely to hurt most big manufacturing companies. There are no plans to review the rigid labor laws or eliminate protection for the services sector.

The real hope for the economy is that exports, which have been growing month-on-month since February, are likely to continue to expand. The yen has strengthened against the dollar and given that the finance minister has ruled out an intervention, it may continue to strengthen to reach ¥85-to-a-dollar by the end of the year, unless the reasons for current strengthening are temporary. A stronger yen, however, does not necessarily mean lower revenues for exporters; the net impact also depends on the export volumes and domestic economic

conditions. A strong revival in world demand, which appears likely, may offset the impact of a stronger yen.

Japan’s fiscal stimulus is expected to start slowing down by the end of this year. It is, therefore, to Japan’s advantage that the recovery in the United States is trailing the recovery in Japan. Demand in the United States will likely rise due to both inventory replenishment and the fiscal stimulus kicking-in in the fourth quarter, and the U.S. fiscal stimulus is likely to play out in 2010. Both these factors will help sustain demand for Japanese exports at a time when domestic measures to prop up demand start to fizzle out.

**Monthly Exports (Million Yen)**



Source: Statistics bureau, Japan

In short, though there are myriad uncertainties, the economy will likely continue to register positive growth, but the momentum could decline.

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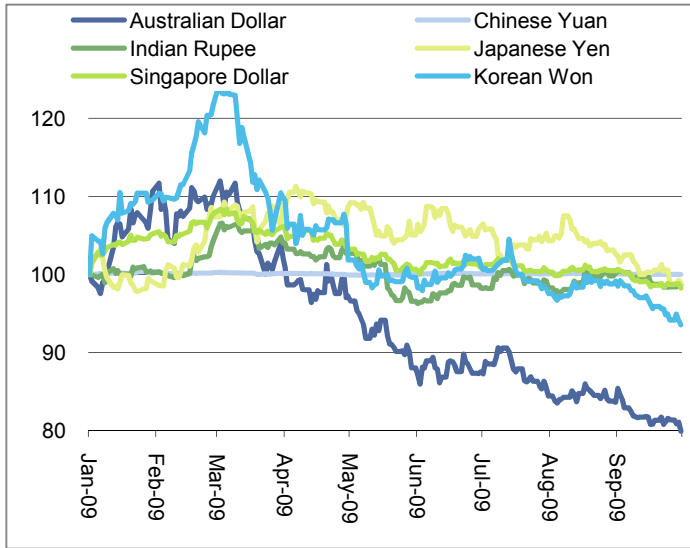
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## Select Economic Indicators

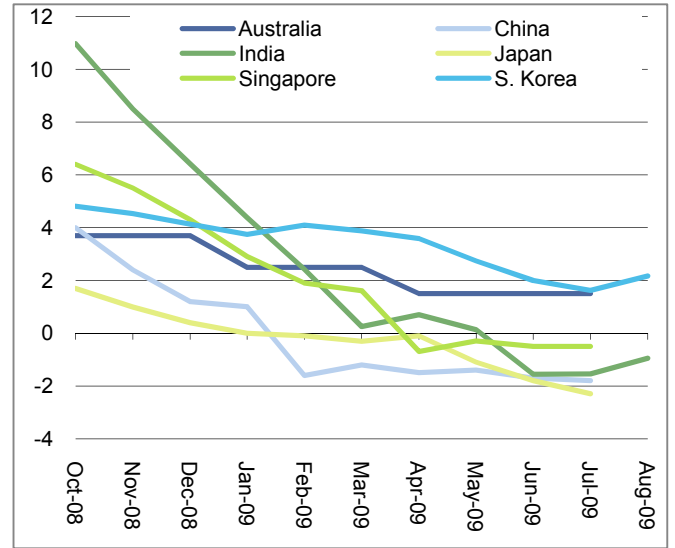
### Indexed Daily Movement of Major Currencies (Jan 1, 2009 to Sep 30, 2009)



Source: Bloomberg

Note: Above 100 means depreciation and below 100 means appreciation. All exchange rates are against the U.S. dollar.

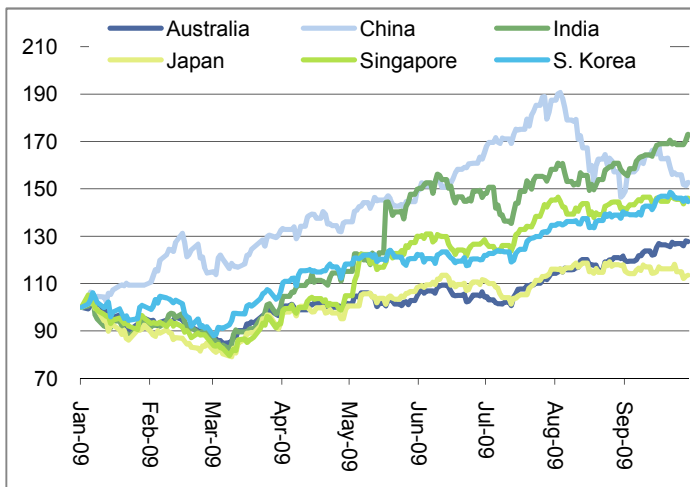
### Inflation Rates



Source: Bloomberg

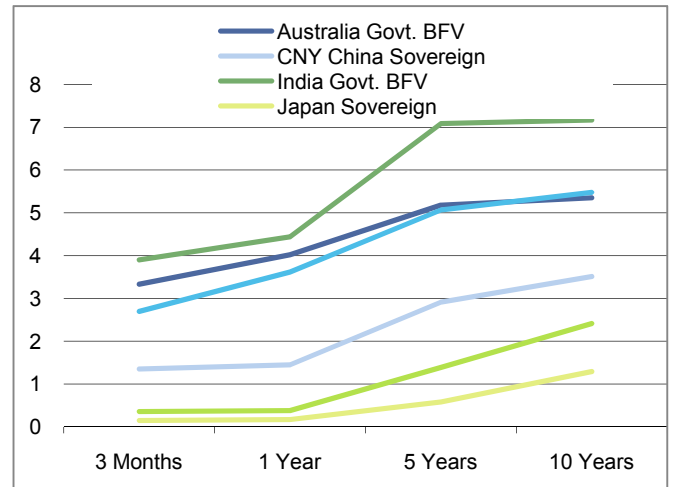
Note: Australia's inflation rate is a quarterly rate. India's is a weekly rate that is averaged.

### Indexed Daily Movement of Major Stock Exchanges (Jan 1, 2009 to Sep 30, 2009)



Source: Bloomberg

### Yield Curves\*



Source: Bloomberg

\* As on October 1, 2009

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