



# Asia Pacific economic outlook

January 2009



A Deloitte Research Report

## Economic Issues that Could Define 2009 (not in order of importance)

- The economic stimulus plans of the U.S. and China working as planned.
- The ability of the U.S. to fund a second stimulus package.
- The inability of most governments to afford big stimulus packages.
- The slowdown in the Chinese and Indian economies.
- Deflation because of falling commodity prices and reduced consumer demand.
- Debt markets for private companies potentially freezing up as government debt issued to fund stimulus plans crowds-out investment.
- Central banks continuing to ease credit costs.
- Interest rate spreads (risk spreads) remaining high because of high risk perceptions.
- Banks shying away from their role as credit-intermediators.
- Trade protectionism increasing as economies slow.
- A depreciating Chinese yuan triggering a trade-war with the U.S.
- Continuing weakness in the balance sheets of companies.
- The discovery of more toxic assets in the books of banks.
- Continuing volatility in global currencies.
- Equity markets remaining weak with investors preferring less risky assets.

## Outlook for Select Asia Pacific Economies

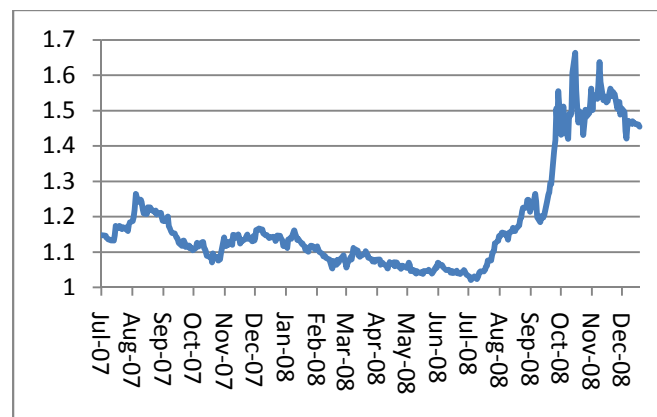
### AUSTRALIA

Australia is in the midst of a major slowdown with all major macroeconomic indicators pointing to this. Third-quarter GDP grew at 1.9 percent (0.1 percent QoQ) compared to 2.9 percent the quarter before. The fall in GDP was because of a fall in domestic demand and exports. The manufacturing sector is not doing well as the Performance of Manufacturing Index contracted for the seventh straight month on a YoY basis. The index was 33.7 in December compared to 32.7 in November (the lowest level since the index started) and 52.7 in April 2008. Data suggests that the index is being dragged down primarily by fall in production, new orders, and exports. A major component of manufacturing — automobiles — has seen a sharp fall in sales.

November saw sales dip by 17.8 percent and 10.7 percent in October. October's export number showed a rise but that was because of still high prices for coal rather than increased volumes.

The Performance of Services Index (PSI) has been declining fairly sharply in the past few months. It was 37.8 in November compared to 42.1 in October and 54.2 in January 2008. Retail sales, part of the services sector, have been falling; it grew at an anemic 2 percent in October compared to 6.9 percent in January. The Performance of Construction Index (PCI) was 32 in November compared to 42.6 in April and 52.4 a year before. Housing finance loans for owner-occupied houses fell by 24.2 percent in October compared to -26.5 percent in September caused by banks' reluctance to lend money to the real estate sector. One reason for this has been the sharp fall in the housing price index. It grew by 2.8 percent in the third-quarter compared to 13.5 percent in the first-quarter of 2008. As a result of the slowdown in all sectors, operating profits of businesses grew by 5.2 percent in the third-quarter compared to 15.7 percent in the second.

### U.S. Dollar vs. Australian Dollar



Source: Bloomberg

These numbers have weighed heavily in the Reserve Bank of Australia's (RBA) decision to cut its cash rate target by one percent to 4.25 percent on December 2. The RBA had earlier cut its benchmark interest rate by 75 basis points to 5.25 percent on November 4 and one percentage point to six percent on October 7. In a note accompanying the December 2 decision, RBA Governor Glenn Stevens said, "The Australian economy has been more resilient than other advanced economies, but recent data nonetheless indicate that a significant moderation in

demand and activity has been occurring.” The Australian dollar was up by over seven percent against the U.S. dollar in December but down by around 41 percent since its peak in July. The fall is the result of the unwinding of the yen-carry trade of which the Australian dollar was a favorite target.

In the near-term, output in Australia will slow but according to the OECD, the economy will not slip into a recession. The OECD forecasts the economy to grow at 1.7 percent in 2009 compared to 2.5 percent in 2008. Considering the forecasts for other developed economies, it looks like Australia will likely come out of this crisis fairly unscathed. However, commodity exports are likely to take a big hit because of the slowdown in China. Inflation will likely come down in the fourth-quarter (Australia releases its CPI number quarterly) and will continue to remain at low levels in the near-term. The median consumer inflation expectation for December from the Melbourne Institute for Economic and Social Research is 2.5 percent, down from 4.4 percent in October. The December inflation number is in the RBA’s comfort range of two to three percent. This could likely give the RBA more leeway to reduce rates during the next monetary policy meeting scheduled for February 3.

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Other reasons for cutting rates are a declining leading index and a falling business investment. Westpac Bank’s leading index for Australia, an indicator of performance in the next six to nine months, has been declining in recent months. The index fell by 0.1 percent in October from September while the annualized growth rate was 0.6 percent. Westpac’s chief economist Bill Evans said, “This suggests weak growth over the coming few quarters.” Business investment has been down suggesting that companies are rolling back expansion plans because of the volatile economic situation and this could likely affect future economic growth. Investment in the third-quarter was 0.6 percent QoQ compared to 7.4 percent in the previous quarter.

The Australian dollar will likely remain range-bound in the near-term — three-month forwards indicate a very small depreciation from current levels. Medium-term levels will continue to depend on whether the yen-carry trade unwinds further. Reduced

commodity prices will probably continue to put downward pressure on the dollar. That said, what will be key to Australia’s economic growth will be whether borrowing costs can be reduced or not. Though the RBA has been aggressively cutting rates, the difference between the three-month interbank rate and the overnight swap rate (a gauge of cash scarcity) was 73.8 points on December 31, 2008 compared to 35 points a year ago.

### **CHINA**

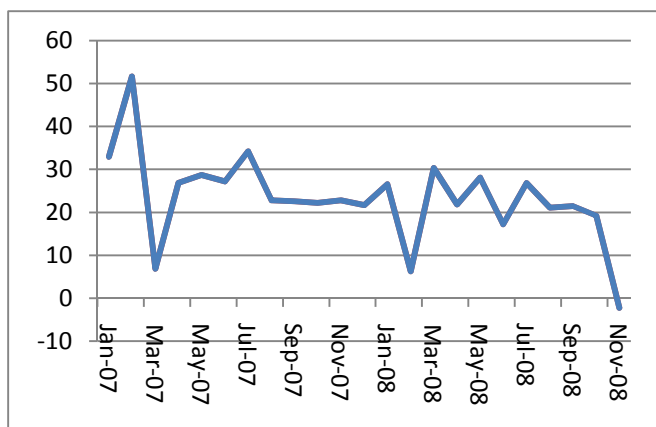
China’s economic slowdown started in the first-quarter of 2008 and recent indicators show that this slowdown is likely to intensify. The first indication of a rather sharp slowdown came in when third-quarter GDP grew at nine percent compared to 10.1 percent in the previous quarter and 11.7 percent for 2008. Factory output in November grew at 5.4 percent, the slowest pace of growth in almost a decade. Factory output grew at 8.2 percent in October while the average growth for the first 10 months of 2008 was 14.54 percent. This has meant that areas such as the Pearl River Delta where many factories are located has suffered heavily and reports indicate that there has been an exodus of migrant workers moving back to their rural hometowns. The

primary reason for the fall in factory output was the fall in exports, a result of global economic slowdown and particularly the slowdown in the United States. Exports fell by 2.2 percent in November; the last time exports shrank was in November 2002. This fall is glaring when compared with data from previous months. Exports grew at an average of 22 percent for the first 10 months of 2008. When compared to the previous month, November’s exports fell by over 10 percent. However, November’s trade balance increased by 5 billion to \$40 billion from October. The rise was due to imports shrinking by 17.9 percent in November because of reduced oil prices, but the economic slowdown could also be a factor. A direct result of this slowdown has been reduced profits. The profits of industrial companies increased by 4.9 percent in the first 11 months of 2008 compared to 36.7 percent a year earlier.

Falling prices have also been responsible for reduced profits. The consumer price index (CPI) grew by 2.4

percent in November compared to four percent in October and 8.5 percent in April. A sharp fall in food prices contributed to the slowdown in November. Producer prices too fell sharply in November. It grew by two percent compared to 6.6 percent in October and 10.1 percent in August due to reduced oil prices. Foreign direct investment (FDI) has shown a decline too. FDI fell by 36.5 percent in November though the commerce ministry has said that FDI rose by 26.3 percent to \$86.4 billion for the first 11 months of 2008. An international investment bank however thinks that companies are likely 'front-loading' investments to gain exposure to the yuan. This is probably because the Chinese government has put a tight lid on speculative investments. The yuan meanwhile has been near constant against the U.S. dollar since August when the People's Bank of China (PBC) started to halt the steady appreciation of the yuan, an appreciation that was badly hurting exporters.

### Export Growth (percent YoY)



Source: Bloomberg

Retail sales grew at a fairly strong 20.8 percent in November, though it was the slowest in nine months. A major reason for the slowdown has been auto sales which grew at 7.7 percent compared to 19.6 percent in October. Petroleum sales too fell in November but

### The macroeconomic leading index in China has been trending downwards in the past months; it went below 100 in September for the first time since 2001.

reduced prices caused the fall. The real estate sector has taken a bad hit after the bursting of the property bubble. Construction of homes, offices, and factories fell by around 16 percent in October compared to a rise of 32.5 percent a year earlier. Property prices too have been falling rapidly in urban areas. To counter the slowdown, along with a previously announced

\$586 billion stimulus plan, the PBC has been cutting rates aggressively. Between October and December, the PBC has cut the one-year best lending rate five times — it has come down from 7.2 percent to 5.31 percent, the last cut coming on December 22 when the PBC cut rates by 27 basis points.

Going forward, the economy will slow down. The PBC has forecast that the economy will grow by about eight percent in 2008 meaning that fourth-quarter growth will be less than seven percent. Eight percent economic growth is critical to China because at that level of growth it can create enough jobs for the 20 million people who come into the workforce annually, thus ensuring social stability to an extent. The macroeconomic leading index in China has been trending downwards in the past months; it went below 100 in September for the first time since 2001. The World Bank has cut its 2009 forecast to 7.5 percent from its 9.2 estimate in June 2008.

One of the big reasons for this predicted fall is reduced factory output. The industrial production leading indicator fell to 5.4 in November from 17.4 in December 2007. The purchasing managers' index stood at 41.2 in December compared to 40.9 in November, a record low. Any number below 50 indicates a contraction. Fixed-asset investment in industry is also showing a slight slowdown. China is currently testing a system where regional countries can settle money in yuan rather than in U.S. dollars for goods imported from China. This could hopefully have the effect of increasing regional trade and thus providing a boost to domestic factory production. However, this is unlikely to have any effect on exports to other customers and it is very likely that total exports are going to be down sharply in the coming months.

Retail sales are also likely to slow down in the near-term. Consumer confidence expectation numbers are sloping downwards. The government is trying to

boost spending by encouraging people to buy on credit but it remains to be seen how it will work because it would be counter-cultural in China — only 20 percent of sales are made on credit compared to 90 percent in the United States. Inflation is likely to remain low in the near-term and there is a chance of deflation if PPI numbers continue to fall the way

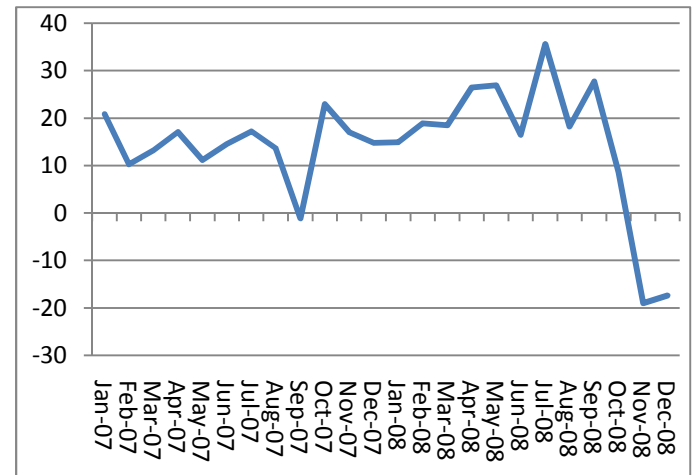
they have. To combat this as well as the general economic slowdown, the PBC will likely lower interest rates till they see the economy recovering. In their third-quarter monetary policy report, the PBC wrote, "In line with the overall strategy of the CPC Central Committee and the State Council and the scientific approach to development, the PBC will carry out a moderately loose monetary policy, adjusting monetary policy operations in response to the changing situation, guaranteeing steady growth of money and credit and sufficient liquidity in the financial system, promoting stable and relatively rapid economic growth, supporting the expansion of domestic demand, safeguarding the stability of the RMB exchange rate and the financial system, and guiding the financial system to play a greater role in bolstering economic growth." As far as the yuan is concerned, "safeguarding the stability of the RMB exchange rate and the financial system" is code that the yuan is not going to be allowed to appreciate. Indeed recent reference rates set by the PBC and three-month forwards indicate a slight weakening of the yuan. Perhaps the bright spot in all of this is the bond market signaling that it expects an economic recovery, a recovery financed by the massive stimulus plan.

## SOUTH KOREA

In comments made on December 11th, Bank of Korea (BOK) Governor Lee Seong Tae said: "Our economy is expected to see very low growth for a significant period of time." These comments were made by Lee after the board at the BOK decided to cut their benchmark interest rate, the seven-day repurchase rate, by 100 basis points to a record low of 3 percent. In a surprise move, the BOK cut rates on January 9<sup>th</sup> by 50 basis points to 2.5 percent and Governor Lee said: "It'll be a very bad year". He then went on to say that it was almost certain that the economy contracted sharply in the fourth-quarter of

and by 19 percent in November because of growth concerns in China and the U.S.

## Export Growth (percent YoY)



Source: Bloomberg

Falling exports has resulted in industrial production (IP) shrinking by 14.12 percent in November and 2.34 percent in October. The components of IP indicate that the shrinkage was across the board with manufacturing falling by 14.8 percent and heavy chemicals by 15.3 percent. Retail sales have been anemic; it grew by just 1.6 percent in October compared to 10.4 percent in August. A downward sloping composite consumer confidence index indicates why retail sales have fallen sharply. The service sector fell by 1.6 percent in November compared to a growth of 1.4 percent in October. The shrinkage was caused primarily by the wholesale, transport and real estate sectors. Record household debt, currently at 148 percent of disposable income, is an important reason why the retail and service sectors have shrunk. The result of this is a three-year high loan delinquency ratio for companies — it reached 1.18 percent in November 2008 compared to 0.92 a year before.

Inflation levels are down from recent highs; the CPI

## The Bank of Korea has forecast that the economy will grow at 3.7 percent in 2008 and 2 percent in 2009.

2008. The aggressive cuts are a reaction to bad economic news. Third-quarter GDP grew at 3.8 percent (0.5 percent QoQ) compared to 4.8 percent in the previous quarter and 5.8 percent in the first-quarter. Third-quarter GDP was dragged down primarily by private domestic consumption and exports. Exports in December shrank by 17.4 percent

rose 4.1 percent in December compared to 4.5 percent in November. Inflation however remains over the BOK's target of 2.5 – 3.5 percent. Producer prices fell by 2.3 percent MoM, the largest fall in 45 years, because of the drop in the price of oil. The won appreciated 17 percent in December but was still down 26 percent in 2008. It is speculated that the

central bank bought won (and sold dollars) in the currency market in order to improve balance sheets of companies before the year-end: many companies have foreign-currency denominated liabilities. In an effort to pump more money into the cash strapped economy, a \$15.1 billion fund will be created to replenish capital and to encourage them to lend. This will come in handy if troubled assets rise as predicted.

In the near-term, it is certain that the economy will slow because of sluggish domestic demand and exports. The BOK has forecast that the economy will grow at 3.7 percent in 2008 and 2 percent in 2009. It grew at 5 percent in 2007. The finance ministry has said that the country is facing increased “downward risks” because of falling demand. Confirming this likely fall in growth is the leading index which fell by 2.8 percent in November (-1.1 percent MoM) and 1.5 percent in October. Industrial production too is likely to fall in the near-term and two indicators portend this. Investment in machinery fell by a huge 43.34 percent in November and 35 percent in both October and September. Investment in equipment fell by nearly 18 percent in November. Low manufacturing and non-manufacturing confidence numbers aren’t going to help either. The profitability survey shows a steep decline; January 2009’s number was 61.6 compared to 99.8 percent a year before. Government tax cuts amounting to \$26 billion and additional spending of \$12 billion will help but is unlikely to prevent a slowdown because the tax cut money could likely be used by households to deleverage rather than to spend.

Inflation levels are likely going to reduce in the coming months because of falling commodity prices and reduced demand. It is likely that inflation will come within the BOK’s inflation target band and thus giving it more leeway to reduce rates. In a statement accompanying the January 9<sup>th</sup> decision, the BOK said they “will do what is needed to improve liquidity conditions and to ward off the risk of a severe slowdown in economic activity.” In a speech given on January 1<sup>st</sup>, Governor Lee said: “We’ll have to take active steps against the possibility that the economic situation may worsen as financial markets become more unstable.” Since it is likely that the economic situation is going to get worse before it gets better, the BOK may cut rates by 25-50 basis points in the near-term

The won is likely to depreciate in the near-term because of the BOK may stop buying won and let the currency depreciate in a bid to boost flagging exports. 3-month forwards show that the market is expecting the won to depreciate by around 7 percent. Despite all this bad news, this crisis is unlikely to approach anything close to the havoc that the 1997 crisis created. ●

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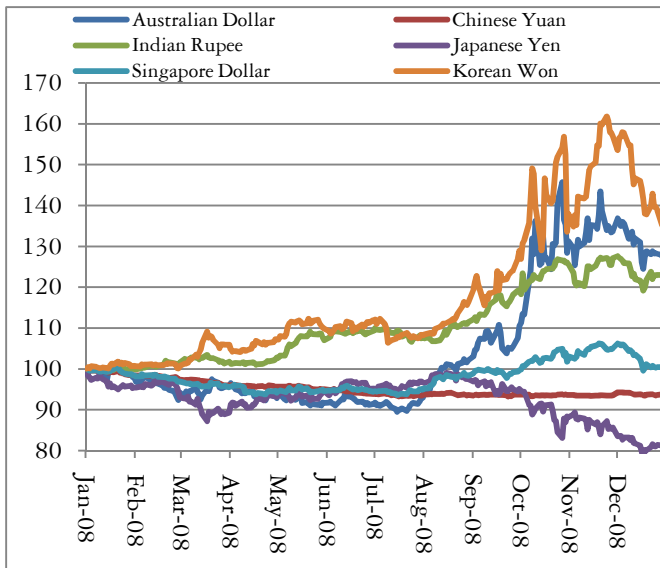
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## Select Economic Indicators

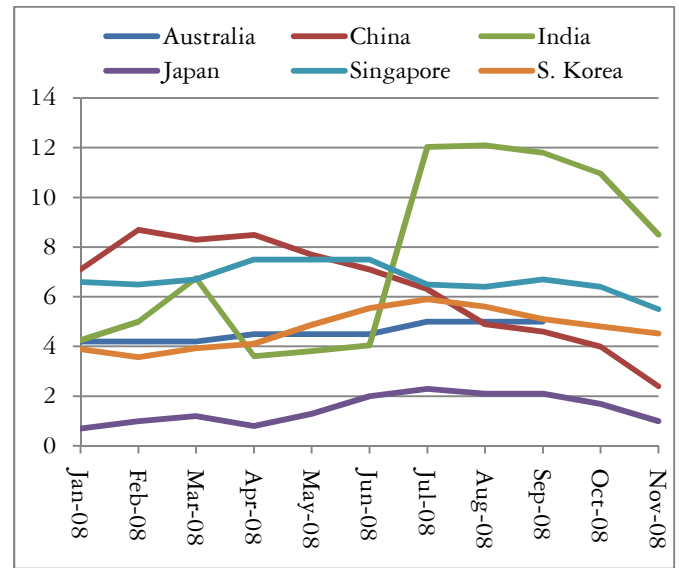
### Indexed Daily Movement of Major Currencies (Jan 1, 2008 to Dec 31, 2008)



Source: Bloomberg

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

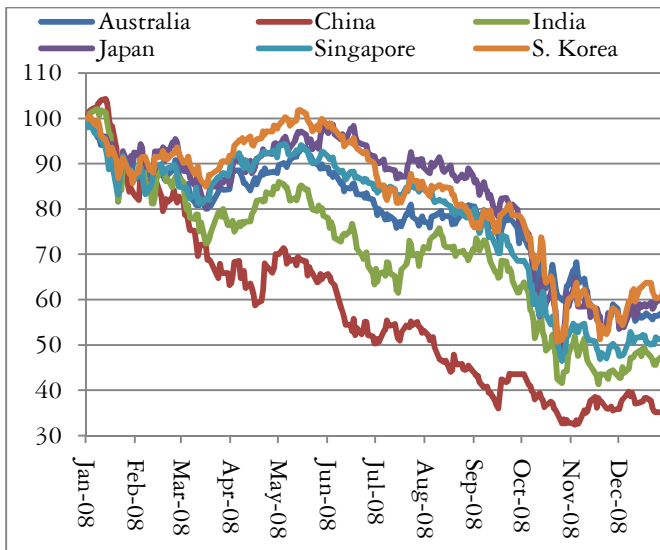
### Inflation Rates



Source: Bloomberg

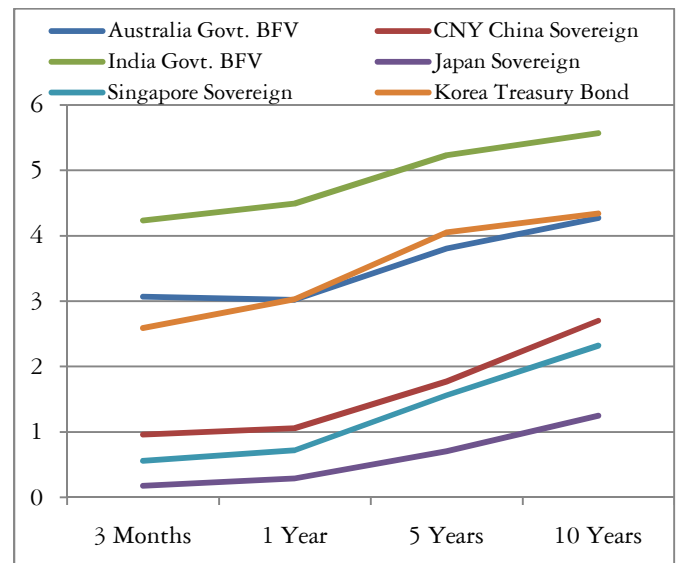
Note: Australia's inflation rate is a quarterly rate. India's is a weekly rate that is averaged.

### Indexed Daily Movement of Major Stock Exchanges (Jan 1, 2008 to Dec 31, 2008)



Source: Bloomberg

### Yield Curves\*



Source: Bloomberg

\* As on January 6, 2009

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