Asia Pacific economic outlook

October 2008

A Deloitte Research Report

Key Takeaways from the Asian Development Bank's Outlook for 2008 and 2009

- With the continuing turmoil in financial markets, the cost of new capital will become higher, and access harder, for developing Asia.
- In 2009 when inflation is reined in, regional growth will slow—also hit by the slowdown in export growth to the G3.
- East Asia is expected to decelerate to 8.0% growth in 2008 and to 7.7% in 2009, from 9.6% in 2007.
- Southeast Asian growth is projected to slow from 6.5% in 2007 to 5.4% in 2008 and to stay around that rate next year.
- South Asia's growth will decelerate from 8.6% in 2007 to 7.1% in 2008 and to 6.7% in 2009.

Outlook for Select Asia Pacific Economies

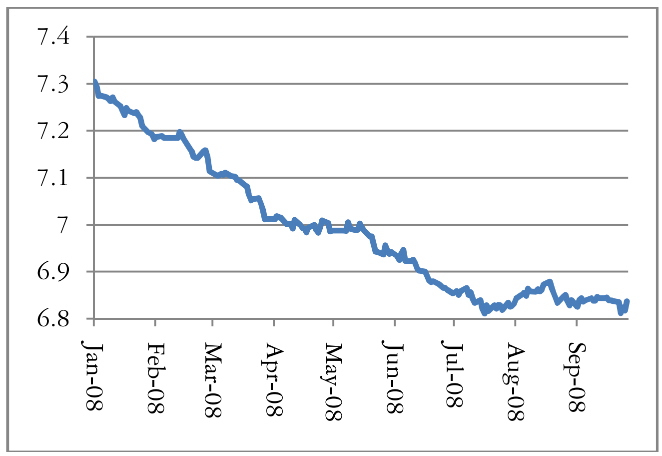
CHINA

In a recent study done by a major investment bank, it was found that out of the last 11 Olympics, 10 of the host nations saw investment and growth fall in the following year — the one exception was the U.S. in 1996. This usually happens because there is such heavy spending before the Olympics and it boosts the economy and an abrupt stop to that spending takes the wind out of the sails. Though Chinese officials are showing a brave face to this report, it must be at the back of their minds particularly since GDP slowed down in the last two quarters. The GDP growth rate in the second-quarter was 10.1 percent compared to 10.6 in the previous quarter. What hasn't helped matters is that the industrial production slowed down rather sharply in August — it grew by 12.8 percent compared to 14.7 a month before and 16 percent in June. The slowdown has the Communist Party's Central Committee worried and they have said that China's focus would be on "ensuring steady and fast economic growth".

Going forward, the focus is going to be on growth only: inflation is passé.

After being at elevated levels for several months, the inflation rate is beginning to level off. Augusts' inflation number came in at 4.9 percent compared to 6.3 percent in July and 7.1 percent in June. Using this opportunity, the central bank, the People's Bank of China (PBC) reduced its benchmark interest rate (1-year lending rate) on September 16th by 27 basis points to 7.2 percent, its first rate cut in almost 6 years. It also cut the reserve ratio requirements of banks by 100 basis points to 16.5 percent and this went into effect on September 25th. This cut also put them in compliance with the Central Committee's edict. The yuan has remained at fairly stable levels over the past few months, a result stemming from the edict. The government also passed some measures to boost the stock market (they cut stamp duty) and they are going to buy shares of their top three banks directly from the market.

Chinese Yuan vs. the U.S. Dollar



Source: Bloomberg

Going forward, the focus is going to be on growth only: inflation is passé. The central government is likely to boost fiscal spending to counter both the Olympic blues as well as the forecast economic slowdown. Consensus forecasts show that China's growth rate for 2008 will be 10 percent and will fall to 9.35 percent in 2009. This is likely to mean that the central bank will cut rates further and/or reduce the reserve requirements of banks. In addition, they may also likely relax credit controls if the situation gets out of hand. Though the central bank will finally do what the Central Committee tells it to do, there is genuine disagreement on what to do. Some senior officials are of the opinion that the central bank should lower rates further and that growth is more important than inflation while officials from the central bank urge caution.

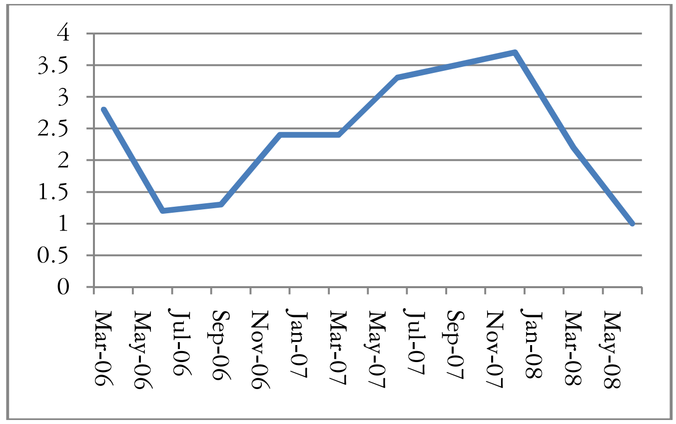
As far as the yuan is concerned, forward contracts show that the market is not expecting much of an appreciation from the yuan, it may likely remain flat. The central bank has already put the brakes on the yuan's appreciation and it is likely to keep it that way because a weak yuan has always been viewed as central to China's economic growth. The PBC is also tightening controls on inflows to prevent any appreciation pressure.

New Zealand

The New Zealand economy is going through bit of a problem to put it mildly. The country entered into a recession in the second-quarter of 2008 — its first in 10 years. Second-quarter GDP growth rate grew at 1 percent YoY compared to 2.2 percent in the previous quarter and 3.7 percent in the last quarter of 2007. This fall in GDP can be largely blamed on the precipitous fall in the housing market. In August 2008, sales of houses fell to a 26-year low. The number of homes sold in August dropped by a whopping 34 percent on a YoY basis and the median home prices dropped by 5.7 percent. As a result of this weakness in the housing market and fears that this could have a domino effect on the economy, the Reserve Bank of New Zealand (RBNZ) lowered its benchmark interest rate, the Official Cash Rate, by 50 basis points to 7.5 percent: the market was expecting a 25 basis points cut. This cut is a sequel to the 25 basis points cut done in the latter half of July. The RBNZ likely waited for several months to make this cut because inflation was on an upward trend and they were watching to see where it would take off to.

The inflation rate in the second-quarter (NZ's inflation data is quarterly) was 4 percent compared to 3.4 percent in the previous quarter and 2 percent in the second-quarter of 2007. Given the recent fall in the price of crude oil, the RBNZ judged that inflation was on the way down and that growth needed a boost. Apart from that, retail sales have been down in the past few months. It started the year strong at 5.9 percent growth but faltered to 1.1 percent in July. Business confidence was at a low but improved because of the larger than expected rate cuts. The story is similar for consumer confidence. The New Zealand dollar has lost some 15 percent against the U.S. dollar year-to-date.

GDP Growth Rate



Source: Bloomberg

Going forward, it is very likely that the RBNZ will cut rates again during their next monetary policy meeting on October 23rd — the market is fully expecting a 50 basis points cut. Setting rates is always a tough decision and the RBNZ expressed that in their September monetary policy statement saying: "The main question we face now is how far and how fast monetary conditions should be eased. If monetary conditions remain too tight for too long, there is a risk that the New Zealand economy enters a prolonged downturn unnecessarily. Depending on the severity, this could result in significant underinvestment and potential financial instability, hampering the long-term growth prospects for the economy."

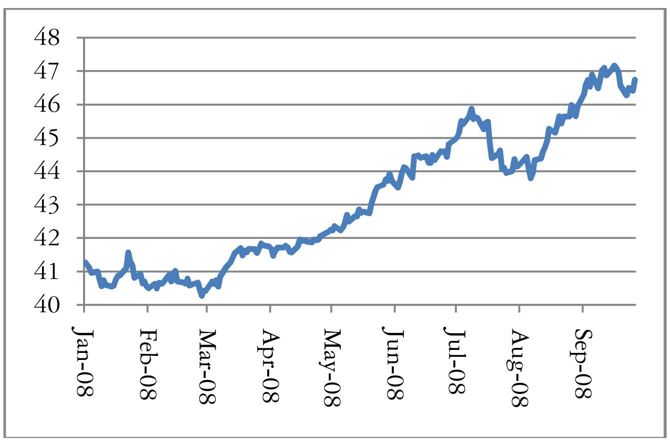
Inflation is likely to peak in the third-quarter and then trend downwards. That is a good thing for the RBNZ because according to the 'Policy Targets Agreement' negotiated with the government, they are obligated to maintain increases in the CPI "between 1 and 3 per cent on average over the medium term." The New Zealand dollar is likely to remain weak in the near-term because of the weakness in the economy as well as the expected rate cuts.

Philippines

Given the flux in the global economy, it's not surprising that the Philippine economy is struggling. The economy has seen a slowing down in both the first and second-quarter of 2008: it grew at 4.7 and 4.6 percent respectively compared to growth of 8.3, 7.1, 6.4 percent in the second, third and fourth-quarter respectively in 2007. One of the reasons for the slowdown has been a reduction in domestic consumption as inflationary expectations have taken root. Inflation has been on a sharp upward trend driven by rise in prices of items such as rice and fuel. Inflation in August came in at 12.5 percent, the highest it's been in 16 years. Comparatively, the inflation rate in August 2007 was 2.4 percent. The central bank, Bangko Sentral Ng Pilipinas (BSP), have been raising rates and this year so far they've raised their benchmark interest rate, the over-night policy rate, by 100 basis points to 6 percent. The last interest rate hike happened towards the end of August. The producer price index has also been on the up though that is not entirely surprising.

The business confidence index for the third-quarter is down sharply from previous quarters and is at its lowest level since the last quarter of 2001. The Philippine peso is down about 13 percent year-to-date and is a result of two reasons: one, poor economic performance has reduced inflows and two, the trade balance started widening rather sharply as imports went up as a result of record crude prices.

Philippine Peso vs. the U.S. Dollar



Source: Bloomberg

Going forward, the focus is going to be on containing inflation and boosting economic growth. In a speech given on September 17th, the governor of the BSP, Amando M. Tetangco, Jr., said that the interest rate hikes were to: 1) address price pressures that were coming more evidently from second-round effects; 2) guide inflationary expectations, to arrest self-perpetration into higher actual inflation; and 3) rein in inflation and allow it to fall within the target range over the policy horizon. Though inflation is likely peaking there is still a chance that the BSP may raise rates to contain lingering inflation expectations. That said, the probability that the central bank is close to ending its tight money policy is high. However, what could play spoil-sport is if manufacturers pass on increased costs to customer's — the producer price index has been on the rise.

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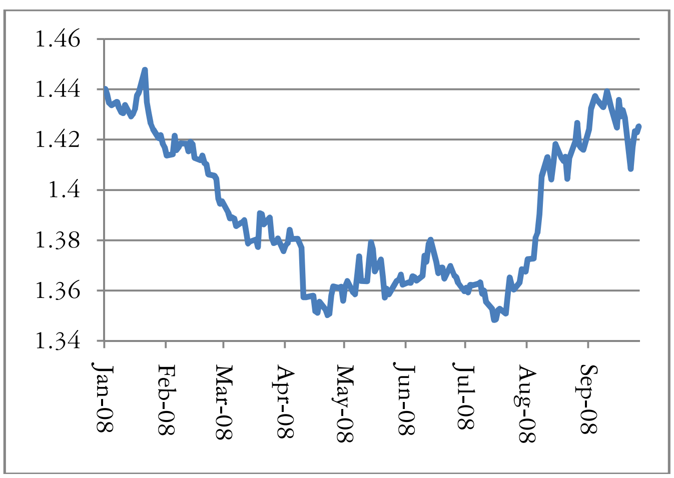
GDP growth is going to slow and the government has already reduced its 2008 growth target twice this year. They first reduced the growth target in May from 7 percent to 5.7 – 6.6 percent. In August, they cut it a second time to 5.5 – 6.4 percent. There are reports that the government will reduce the target for the third time. The government is already planning a raft of fiscal measures to boost the economy but as always, if the fiscal spending plan doesn't have a mechanism to boost consumer spending, it will be cosinderably difficult to achieve..

Singapore

Hearing good news in the Asia Pacific region economies these days seems to be a fairly distant fantasy — everyone seems to be having one problem or the other. Singapore is no exception to this. A hub of commerce and finance, Singapore seems headed towards a slump. Second-quarter GDP growth came in at 2.1 percent YoY, a rather large fall from 6.9 percent the quarter before. A consensus is forming that the third-quarter GDP growth number, due out in October, will show Singapore slipping into a recession. One of the key reasons for this slowdown seems to be the slowdown in exports. Non-oil domestic exports in August fell some 13.8 percent, the largest fall in 20 months. Augusts' decline in exports was the fourth consecutive month in which exports fell. Another key reason was decline in manufacturing growth — manufacturing in August fell by 12.2 percent and in July it fell an astounding 21.5 percent YoY. A fall in bio-medical production was partly responsible for this dip in manufacturing growth. Manufacturing business expectations show a rather sharp fall in expectations. It also hasn't helped that tourism, one of the mainstays of the Singaporean economy, has fallen in recent months too. Given all this bad news, it's no surprise that the economy is sliding down.

Inflation still remains at fairly high levels – the inflation rate in August was 6.4 percent but it has leveled off from 7.5 percent levels seen from April to June. Nevertheless, it is still uncomfortably high for the Monetary Authority of Singapore (MAS), the central bank. However, despite high inflation, they haven't hiked interest rates recently and the last time they hiked rates was in January 2008 when they did so by a mere 5 basis points. That's likely because monetary policy in Singapore is done through other ways. The central bank does monetary policy by targeting the trade-weighted exchange rate (real effective exchange rate) rather than interest rates. Monetary policy decision making has always been opaque in Singapore: the MAS doesn't even publish the rate it targets. The Singapore dollar, year-to-date, has been at fairly stable levels. The dollar did however strengthen in the middle of the year because the MAS let it appreciate to ease inflation but it started depreciating again and is currently back at levels seen at the start of the year.

The Singapore Dollar vs. the U.S. Dollar



Source: Bloomberg

Going forward, as stated, it is likely that there will be a slowdown in the economy. The government has themselves narrowed their estimate for the year from 4-6 percent to 4-5 percent. However, Lim Hng Kiang, Minister of Trade and Industry is reported to have said that the economy could grow less than 4 percent. Even the finance minister, T. Shanmugaratnam, is reported to have said that the possibility of a recession can't be ruled out. The government has also raised its domestic inflation forecast to 6-7 percent from 5-6 percent (the initial forecast was 3.5-4.5 percent). As far as monetary policy is concerned, since the monetary policy making process is opaque, it is very unclear what they'll do in terms of interest rates. The MAS are well known inflation-hawks and if inflation gets out of hand, they may let the Sing dollar strengthen a little bit but that could hurt already sagging exports. Singapore is indeed facing some serious challenges ahead

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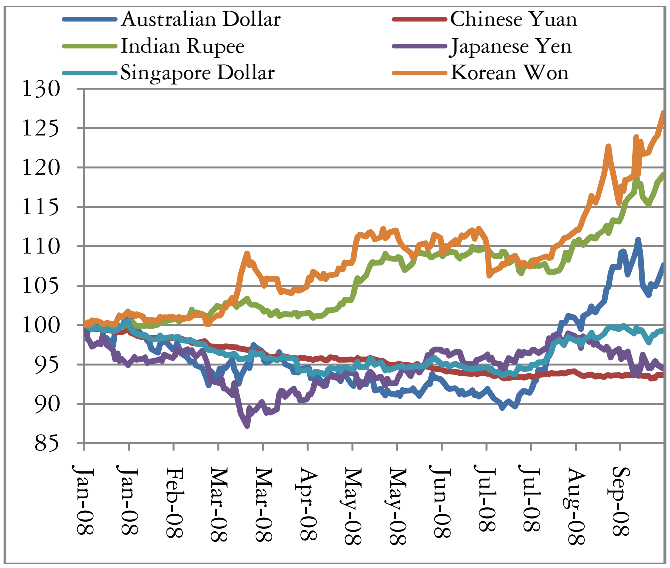
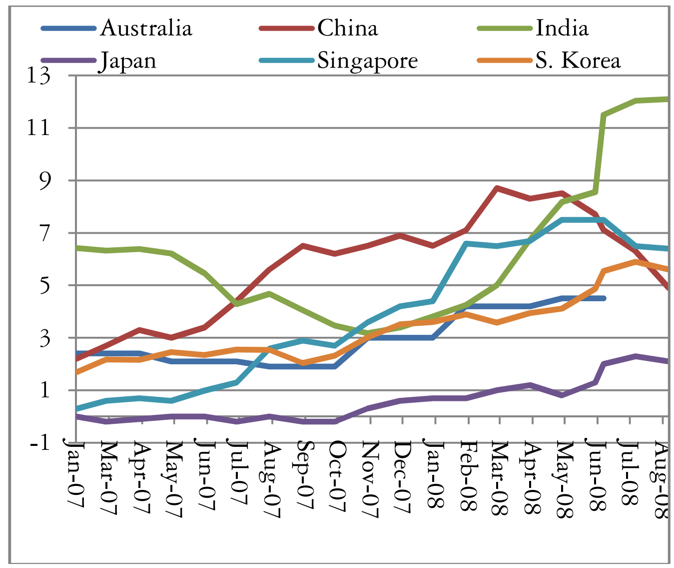
Select Economic Indicators

Indexed Daily Movement of Major Currencies (Jan 1, 2008 to Sept 29, 2008)



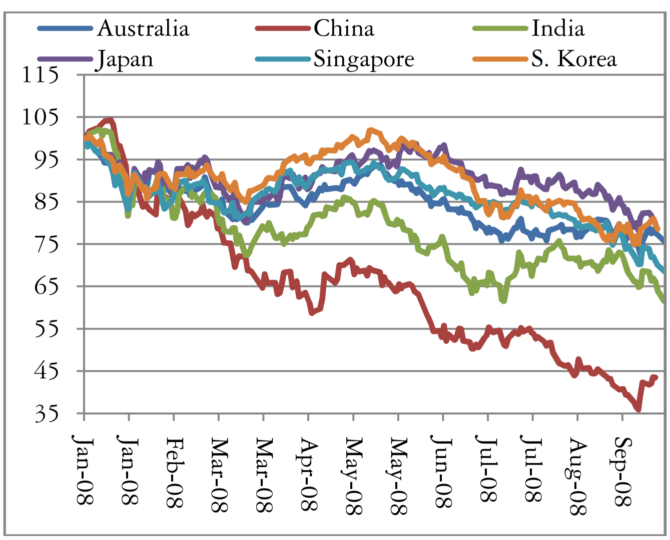
Note: Above 100 means depreciation and below 100 means appreciation. All exchange rates are against the U.S. dollar.
Source: Bloomberg

Inflation Rates



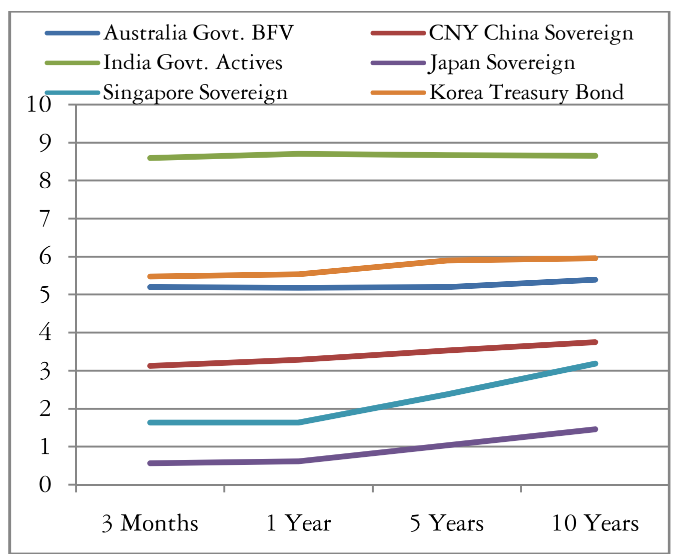
Note: Australia's inflation rate is a quarterly rate. India's is a weekly rate.
Source: Bloomberg

Indexed Daily Movement of Major Stock Exchanges (Jan 1, 2008 to Sept 29, 2008)



Source: Bloomberg

Yield Curves*



* As of September 30, 2008.
Source: Bloomberg

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