



# Asia Pacific economic outlook

November 2008



A Deloitte Research Report

## A Note on the Asia Pacific Region

There's a saying in international economics: "If the U.S. catches a cold, the world sneezes." Translated, it means that if the United States economy, the biggest economy in the world and arguably one of the biggest drivers of global economic growth, were to slow down a number of economies around the world would feel its effects. Nowhere was this felt to be more relevant than in Asia, a region that has become one of the biggest suppliers of manufactured goods and services to the United States. However, over the past couple of years, many experts deemed that the old adage no longer applied to Asia as it had "decoupled" itself from the U.S. economy — Asian economies were growing on their own steam and not because of the United States. Enter the current U.S. financial crisis, and this thinking has again been turned on its head. The United States has now entered into a recession and a good part of the Asia Pacific region is suffering from contagion. This implies that modern economies are not just interconnected through trade, but also through complex financial pathways.

Due to the global crisis, equity markets in Asia Pacific have been hit hard and there's sharp volatility in the markets. A simple measure of the level of volatility — the standard deviation — shows the Nikkei to be at 1186 in October as compared to 426 in September. Some countries' volatility measures doubled from September to October while Korea's increased some fivefold. Some central banks in the region have sharply cut interest rates as well as lowered banks' reserve ratios, but these actions seemed to have had no effect. Credit Default Swap spreads, an indicator of how risky countries or companies are perceived to be, are reaching new peaks. The malaise has started to extend into the real economy with industrial production numbers falling in recent months.

So what's next? The export-dependent region will get hit as the slowdown in the United States and Europe deepens — GDP growth will likely be subdued for the next couple of years. Australia, an exporter of commodities, will get hit because of falling commodity prices. Central banks will most certainly reduce interest rates as well as cut reserve ratios; they have been lucky because inflation has started to show signs of tapering off as a result of cooling commodity prices. Governments will also chip in with some

amount of fiscal priming. However, there is a limit to what both can do. Central banks cannot go all the way to zero; theoretically while that number is zero, practically the number is dependent on the country's inflation. Governments don't have unlimited budgets (the Chinese government however does have a huge amount of money at their disposal) and the Asian Development Bank says that developing countries in Asia will face problems in financing their spending because investors will demand higher yields. It is likely that steps by neither central banks nor governments will work fully as this is a crisis of confidence more than anything else. The Japanese situation in the 1990s is a prime example of this scenario, where neither fiscal nor monetary measures worked because consumers had lost their faith and refused to spend. There is also a high probability of this happening in Asia this time around.

## GDP Growth Rates

	2007	2008*	2009*
Australia	4.167	2.489	2.244
Bangladesh	6.316	7.006	5.616
China	11.9	9.739	9.25
Hong Kong SAR	6.368	4.087	3.471
India	9.337	7.925	6.938
Indonesia	6.316	6.077	5.512
Japan	2.08	0.691	0.465
Korea	4.973	4.116	3.49
Malaysia	6.347	5.75	4.75
New Zealand	3.217	0.651	1.475
Pakistan	6.381	5.8	3.5
Philippines	7.187	4.404	3.796
Singapore	7.715	3.617	3.451
Thailand	4.753	4.735	4.528
United Kingdom	3.026	0.988	-0.128
United States	2.028	1.572	0.055
Vietnam	8.48	6.304	5.456

Source: International Monetary Fund

\* = IMF projections

In what may become a vicious cycle, banks will slow down their lending to both companies and individuals and this will add further downward pressure to already slowing economies. Most major currencies in the region will see significant downward pressure in the near term though the yuan

and yen will be exceptions. Companies will most likely be hit because of the slowdown in consumption as well as the slowdown in economies. There have been reports that a number of companies in the region could get hit badly by being on the wrong side of currency bets, but whether this will be a widespread phenomenon or not is yet to be ascertained. The number of companies hit could be fairly high because many currencies depreciated very rapidly without warning. The equity markets will likely remain volatile till the crisis in the United States is sorted out, and foreign institutional investors will stay away for some time to come. Asian equity markets will thus take a long time to get back to their previous highs.

The Asia Pacific region is lucky in the sense that unlike the Western economies they are not facing a financial crisis, but rather a consumption-led slowdown — the former would have been catastrophic (think of the 1997 Asian crisis). The unknown, however, is how a China slowdown will affect South-East and East Asian countries — they are heavily dependent on China for their growth. It is likely that a China slowdown will have a significant effect on their growth. That said, the region is also unlikely to suffer the kind of slowdown that the United States or the United Kingdom will suffer. However, this offers little solace. Most of Asia is developing and has hundreds of millions of people below the poverty line — any slowdown in economic growth is likely to mean that these people will bear the brunt.

## Outlook for Select Asia Pacific Economies

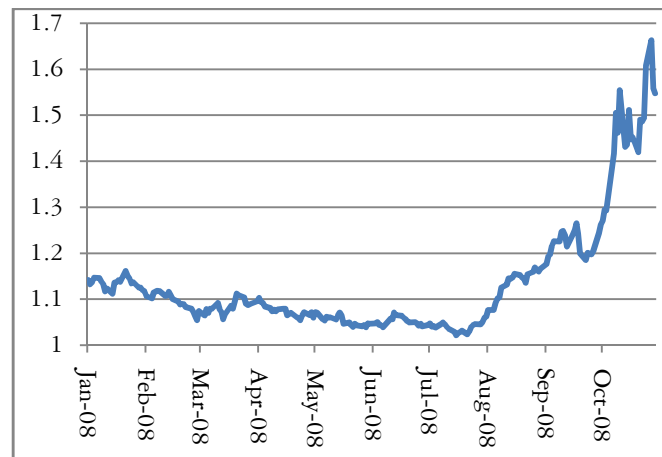
### AUSTRALIA

From being a rock solid economy for many years, Australia is staring in the face of an economic slowdown. There is bad news all around. The second quarter GDP suffered a sharp fall to 2.7 percent compared to 3.3 percent in the previous quarter and 4.2 percent in the last quarter of 2007. The services sector shrank in September; it has now been shrinking for six straight months. Consumer confidence is plummeting to new lows — the index fell 11 percent to 82 in September from the previous month; this is the largest fall in over two years. It is the ninth straight month that the index is below 100

(any reading below 100 indicates that more consumers are pessimistic). Inflation for the third quarter came in at five percent (Australia reports its inflation on a quarterly basis), the highest it's been this decade. Producer prices rose sharply in the third quarter to 13.3 percent compared to 8.5 percent in the previous quarter. Equity markets in Australia, along with other equity markets in the region, have fallen hard; Australia's index has fallen some 40 percent this year. However, what has proven to be truly catastrophic is the fall in the Australian dollar. The dollar lost a little over 20 percent of its value in October alone. The Australian dollar has long been a favorite of the yen carry trade but October saw a massive winding down of the carry trade, and as a result the dollar depreciated.

These problems have led to the central bank reducing their interest rates sharply. On November 4<sup>th</sup>, the Reserve Bank of Australia (RBA) reduced its benchmark interest rate (cash rate) by 75 basis points to 5.25 percent. In early October, along with other central banks, they reduced interest rates by 1 percentage point to 6 percent. In early September, the RBA had cut rates by 25 basis points to seven percent. In a statement released after the 75 basis points cut, RBA Governor Glenn Steven said, "Recent reductions in borrowing rates, the depreciation of the exchange rate and the fiscal stimulus announced in October will work to assist growth in the period ahead, but deteriorating international conditions and falling commodity prices will have a dampening influence. On balance, it appears likely that spending and activity will be weaker than earlier expected."

### Australian Dollar to the U.S. Dollar



Source: Bloomberg

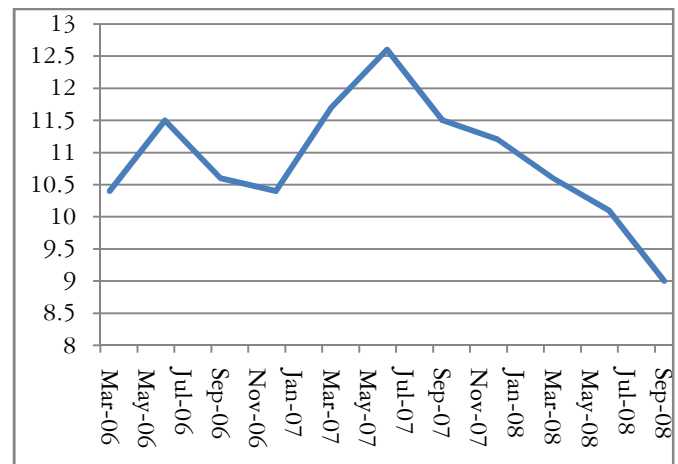
Going forward, a sharp slowdown in GDP can be expected. GDP growth in 2007 was 4.16 percent; it is expected to be 2.48 percent in 2008. As a result of the monetary policy on November 4<sup>th</sup>, it is unlikely that the RBA will cut rates in the near-term but that is dependent on how the economy performs. If the economy does perform worse than expected, it will cut rates during their December meeting. The RBA does have room to cut rates because inflation is forecast to fall in the last quarter on the back of weakened commodity prices. However, the RBA has cautioned that cutting rates may take a backseat to fighting inflation, but that's a worry only if inflation remains high — a distant possibility at the moment. Inflation may spike a little bit because the forecast for the wheat crop harvest is well below the estimate. The dollar is likely to remain weak in the near term as the yen carry trade may still push the dollar downward, and Australia is a big exporter of commodities such as iron-ore and coal and the prices of both have taken a hit. Its other commodity exports such as gold have also fallen in price. However, the most important reason for a weak dollar is that China is a major importer of commodities from Australia and the slowdown in the Chinese economy is likely to mean a reduced demand for commodities. This coupled with the price fall is going to keep the Aussie dollar under pressure for some time to come.

## CHINA

The third quarter GDP growth number was bad news for China. It was expected that the economy would slow down from 10.1 in the second quarter, but nothing prepared it for the nine percent growth rate in the third quarter. While this growth rate would surely be accepted by pretty much every country in the world, especially during these trying times, this number is well below where China's policy makers would like it to be. The slowdown was on the back of reduced exports. Though statistics show exports to be growing at a fairly good pace, they are up because prices have gone up and not because volume is up. In fact, the volume of exports has been on a downward trend since last year (export orders in the third quarter have been at their lowest since 2005). Industrial production is down sharply; it grew at 11.7 percent in September compared to 12.8 percent in August and 17.4 percent in January. Industries in China have been hit by the rising yuan as well as rising costs: average wages are rising at around 20 percent year-on-year and the producer

price index was up by a relatively high 9.1 percent in September. Industrial production is also down partially because steel output has fallen considerably because of reduced demand. The macro leading index is currently at reduced levels and the business climate survey shows reduced optimism. Home sales fell 55.5 percent in Beijing and 38.5 percent in Shanghai year-on-year for the first eight months of the year. There is however some good news on the inflation front. Inflation in September was 4.6 percent, down from 4.9 percent the month before and 8.5 percent in April. A likely reason for this fall in inflation can be partly attributed to price freezes that the government imposed on a number of goods. Because of this reduced inflation, the People's Bank of China (PBC) has been aggressively cutting interest rates. It cut its benchmark interest rate by 27 basis points in September to 7.2 percent. On October 8, it cut rates by a further 27 basis points to 6.93 percent and on October 30, it cut rates again to 6.66 percent. The PBC has also relaxed lending quotas. In addition to this the government has said it will introduce fiscal measures and is making a pointed effort to reform the rural sector. The yuan has been fairly steady through the month because the central bank has stepped in to prevent any appreciation that could hurt many exporting firms.

## China's GDP Growth Rate (% YoY)



Source: Bloomberg

Going forward, it is highly likely that the economy will slowdown in the fourth-quarter. The IMF is forecasting a growth rate of less than 10 percent this year. There are two fears that the Chinese government has, one is inflation and other is joblessness. Now that inflation has been tackled, their full attention is on the economy. It is virtually

certain that the PBC will continue to reduce their benchmark interest rates till they see an uptick in the economy. They will also likely reduce the reserve requirements of banks and also their lending quotas. The government will also likely increase its fiscal spending in an effort to boost the economy. The government is already providing some incentives to boost the property and equity markets but it is very unclear whether they will be successful. Early results of the equity market incentives show that they are struggling. The government is likely to continue the increased tax rebates they are giving for garments and textiles, two sectors that have suffered from the yuan rise. Premier Wen Jiabao said: “We need to use every means to prevent the financial crisis from having an impact on the growth of the real economy” but the fact is that the real economy is already feeling the impact.

The central bank is very likely to keep the yuan steady and unlikely to let it appreciate despite the appreciation pressures. A number of companies have suffered heavily and since many influential policy-makers view a fixed yuan as being key to China’s high economic growth, all efforts will be made to keep the yuan steady. The market already views this as the outcome. Around 3 months ago, non-deliverable forwards of the yuan showed a 10 percent appreciation: they now indicate that the yuan will depreciate by 2 percent. That said China is not on the brink of a slump but more a slowdown. However, the effects of a slowdown in China will be much worse than slowdowns in other countries. A China slowdown will also have reverberations in other countries in the region such as Japan and the ASEAN countries which have become heavily dependent on China.

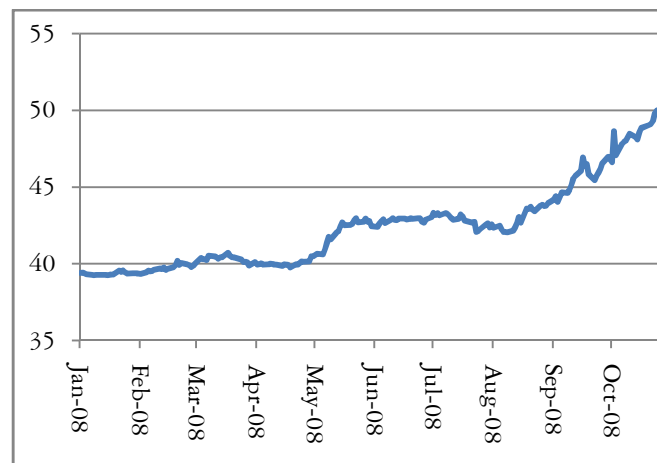
## INDIA

After several years of being in the spotlight, India is now finding out that it’s not necessarily the best place to be in. India was hailed as being a paragon of good, sustainable economic growth — a country sure to become an economic superpower and a driver of global economic growth along with China. Now the model looks like it has several challenges to it. The first alarm bell that went off was the 10 percent plus inflation that India has had since early June. It reached a peak of 12.91 percent in early August but has since reduced slightly but it is still well in the danger zone. The biggest shock of all was the August

industrial production number: it grew at 1.3 percent compared to 7.4 percent the previous month. The number may well be an aberration but it reflects problems in the real economy. After the release of the industrial production data, analysts cut the 2008 growth forecast to around 7.7 percent: it was earlier 7.9 percent.

The equity markets have taken a fallen sharply in India (over 55 percent this year) perhaps reflecting the general view that the Indian markets were overvalued. Foreign institutional investors (FII’s) have left in droves and their net investment by in the first 24 days of October was -\$3.3 billion. The exit of foreign investors has had a devastating effect on the Indian rupee — the rupee went below 50 to 1 U.S. dollar, the lowest it’s been in many years (it has recovered slightly since then). The currency was also badly hit as oil prices took their effect on the trade balance. While a depreciating currency is sometimes good for exporters, it isn’t now because no one is buying (China is an example). Since India is a net importer, a falling currency will only worsen the trade deficit.

## Indian Rupee to the U.S. Dollar



Source: Bloomberg

As a result of the bad news, the Reserve Bank of India (RBI) cut its benchmark interest rate by 1 percentage point to 8 percent on October 20<sup>th</sup> and by a further 50 basis points to 7.5 percent on November 1<sup>st</sup>. It also cut the reserve requirements of banks by 250 basis points in several installments in October and by another 50 basis points on November 1<sup>st</sup>. This reduction is expected to free up over 1 trillion rupees. However, banks have tightened their credit to borrowers and this is leading to a slowdown in the

property markets as well as retail markets. Perhaps the most important move made by the RBI on November 1<sup>st</sup> was to reduce the statutory liquidity ratio (the SLR is used by the federal government to cheaply finance their deficit) by 100 basis points to 24 percent. Financial institutions in India are happy because they have been asking the RBI for a long time to reduce the SLR — having their money in government bonds has a high opportunity cost.

Going forward, the economy will most likely slow down: a preview was already seen in the second-quarter. Again, like China, the Indian economy is not in a slump but a slowdown. Industrial production will likely be above the August number but nowhere close to heydays seen in 2007 — it is likely to be closer to the June and July numbers when they came in at 5.4 and 7.4 percent respectively. Inflation will likely come down from the highs being seen now and settle at sub-10 percent levels. This drop will be because of the massive fall in commodity prices. It can only be hoped that the RBI views this drop in inflation as more a result of lowered commodity prices than its tight monetary policy. However, it is now forecast that the winter harvest will be lower than expected and this could contribute to inflationary pressures.

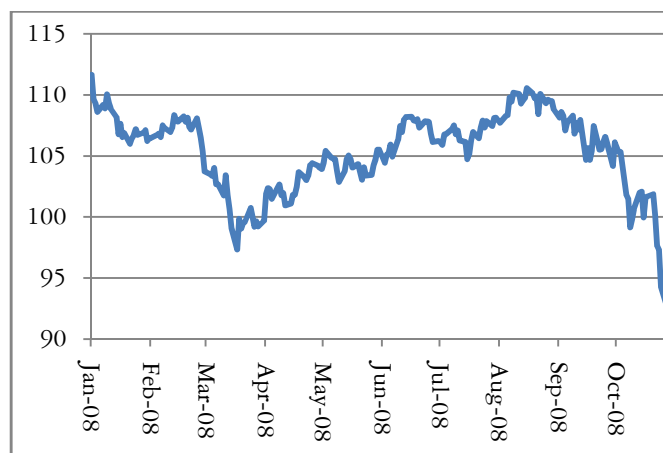
The RBI will likely cut interest rates by another 50 basis points before the end of the year and will also likely cut banks' reserve requirements because it is likely that the liquidity crunch will persist. The rupee, in the near-term, will remain subdued because of investor outflows. A ban on certain kinds of foreign investors was relaxed to help the equity and currency markets but it doesn't seem to be helping. Relaxations of regulations regarding companies' external borrowing (to help boost the rupee) are also not working and will likely not work in the future because of tight credit conditions. It is highly likely that the banks will continue to tighten their lending standards and while this may be good in the longer-term, it will have a negative impact on the economy in the near-term.

## JAPAN

Japan is entering into a recessionary phase and everything points to that. Second-quarter GDP growth was 0.7 percent compared to 1.2 percent in the first quarter. Consumer sentiment in the economy remains at near record lows. In September,

the quarterly Tankan Survey (Business conditions forecast –large enterprises) slipped into negative territory for the first time in 5 years. Retail sales in September grew at a negative rate while inflation-adjusted living expenditure by all households fell by 4 percent in August. Industrial production in September grew at an anemic 0.4 percent though it was a step-up from the previous month's number which was -6.9 percent. The Bank of Japan wrote: "Economic activity in Japan has become increasingly sluggish due to the effects of earlier increases in energy and materials prices and the leveling-off of exports. Compared with the interim assessment conducted in July, both exports and domestic private demand in the first half of fiscal 2008 seem to have been weaker, against the backdrop of a slowdown in overseas economies and a decline in real purchasing power reflecting deterioration in the terms of trade."

## Japanese Yen to the U.S. Dollar



Source: Bloomberg

The yen rose to 13-year highs against the U.S. dollar as the yen carry-trade started unwinding. Investors started to unwind global assets and pay back yen-denominated loans. As the yen started rising, it accelerated the unwinding because borrowers thought they would be hit by the rising exchange rate. The yen has fallen from its highs because the Bank of Japan (BOJ) is expected to intervene in the markets. Core-inflation (less food) in September was 2.3 percent compared to 2.4 percent in August. However, the good news is that excluding food and energy, the inflation rate was a negligible 0.2 percent compared to 0 percent in August. It is perhaps against this background that the BOJ, which watches inflation very closely, decided to cut its benchmark interest rates (unsecured overnight call loan rate) on

October 31<sup>st</sup> by 0.2 percent; they fell from 0.5 percent to 0.2 percent. In cutting rates, the BOJ said: “the Bank judged that a reduction in policy interest rates and a further increase in the flexibility of money market operations were necessary to maintain accommodative financial conditions.”

The near-term is unlikely to bring any good news for Japan. The BOJ has itself said that “the rates of real GDP growth for fiscal 2008 and fiscal 2009 are likely to be around 0 percent and around 0.5 percent, respectively.” If the growth for fiscal 2008 is forecast to be 0 percent, it can only mean that the third and fourth-quarter GDP numbers are not going to be pleasant. The government has announced a \$51.5 billion package to stimulate the economy while the central bank has said that it “will continue to do its utmost to facilitate a return of Japan's economy to its sustainable growth path with price stability through maintaining accommodative financial conditions.” The government package includes tax relief on housing loans, looser rules on capital adequacy ratios for banks among other measures. Whether they will actually stimulate the economy is a big question. Japan's history with government stimulus has had its challenges — the last stimulus by the government didn't work very well. As far as the Bank of Japan is concerned, there is really not much they can do. They are perilously close to a liquidity trap (0 percent interest) and it is unlikely they will reduce interest rates further (this rate cut was passed with a tie-breaker). The key to Japan getting out of its problem will be to get consumers to increase their spending. Spending by households is down and any government measures should focus on getting this up.

The inflation rate is certain to come down because most of the CPI rise was attributable to energy price rises. With a fall in commodity prices, it is certain to come down dramatically. The yen is another matter altogether. Though the BOJ will almost certainly step in to stop any rise in the value of the yen, there is no clarity on the size of the yen carry-trade. If there is a further rush to unwind, there will be a problem. That said, the reduction in interest rate may see a revival of the yen carry-trade and this will lead to downward pressure on the yen. ●

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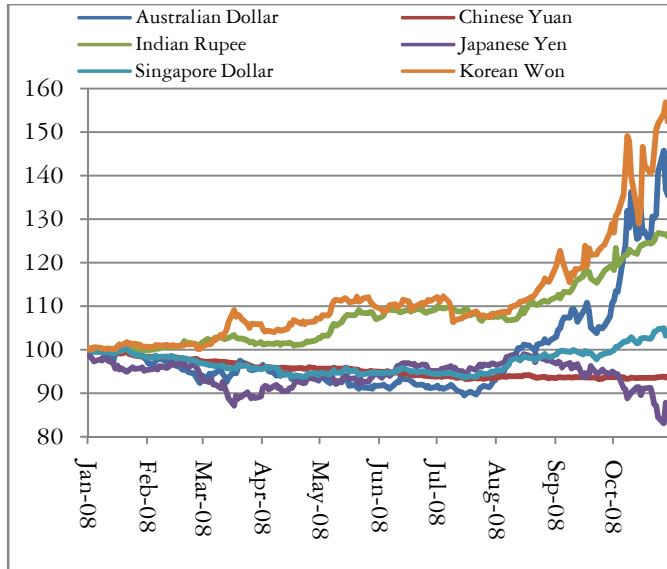
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## Select Economic Indicators

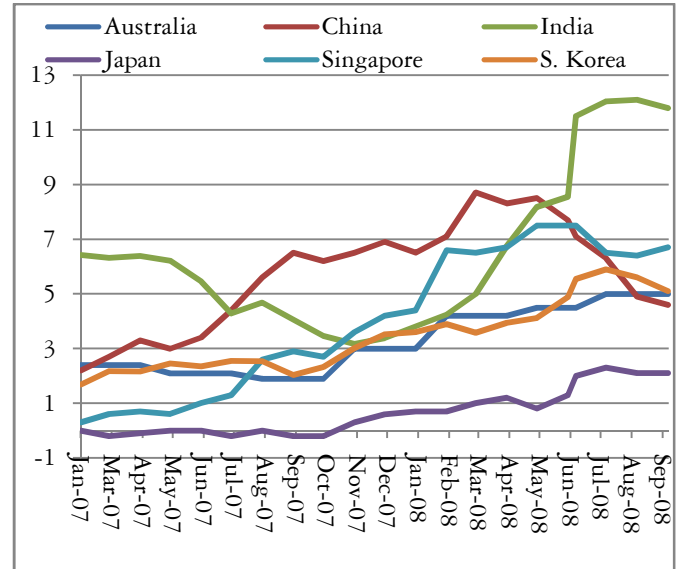
### Indexed Daily Movement of Major Currencies (Jan 1, 2008 to Oct 29, 2008)



Source: Bloomberg

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

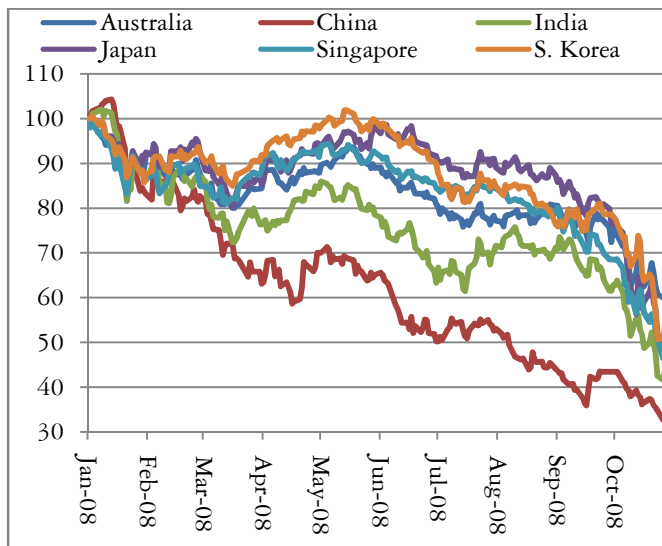
### Inflation Rates



Source: Bloomberg

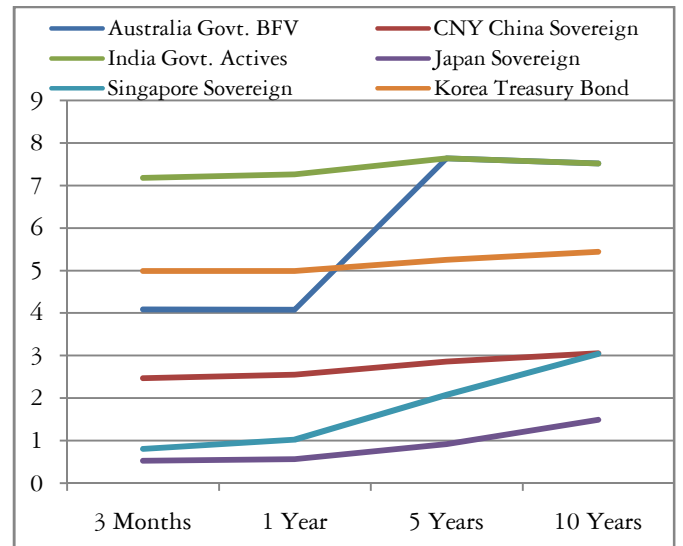
Note: Australia's inflation rate is a quarterly rate. India's is a weekly rate that is averaged.

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



Source: Bloomberg

### Yield Curves\*



Source: Bloomberg

\* As of October 29, 2008.

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