



# Asia Pacific economic outlook

July 2008



A Deloitte Research Report

## Noteworthy news in the Asia Pacific region in June 2008

- According to the Asian Development Bank, emerging Asia will grow by 7 percent in 2008, down from 8.7 percent in 2007.
- China reduced its subsidies on fuel and hiked prices by 18 percent.
- The inflation rate in India jumped to double digits: the central bank raised interest rates by 75 basis points and increased the reserve ratios of banks.

## Outlook for Select Asia Pacific Economies

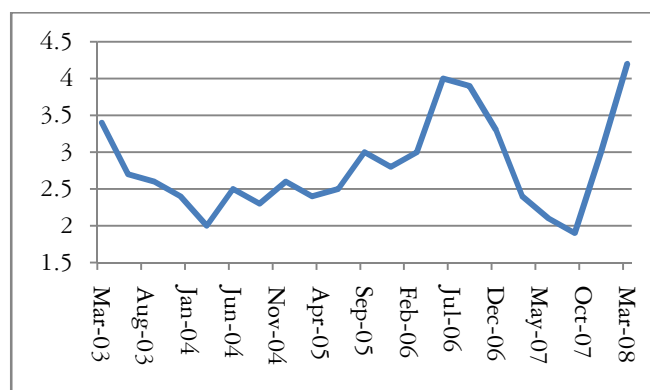
### AUSTRALIA

Australia's economy has been booming — relatively speaking, that is. The economy grew by 3.6 percent in the first quarter of 2008, down from 4.3 percent in the previous quarter. Nevertheless, its growth in the first quarter of 2008 was higher than the average of the past 12 quarters. Inflation in the first quarter of 2008 — Australia's consumer price index (CPI) number is released on a quarterly basis — was 4.2 percent, up from 3 percent in the previous quarter. Australia's benchmark interest rate, the cash rate, is currently at 7.25 and has been constant since the central bank increased it by 25 basis points on March 5, 2008. Producer prices in Australia were on their way up; they increased by 4.8 percent in the first quarter of 2008, up from 2.8 percent in the previous quarter. The Australian dollar (AUD) has appreciated vis-à-vis the U.S. dollar by around 10 percent in 2008 and by around 25 percent since the start of 2007.

In the near term, the AUD is very likely to gain parity with the U.S. dollar. As of June 25, the AUD was trading at around 1.04 to the U.S. dollar. The AUD did fall a little bit on the possibility that the central bank would not raise rates. However, Australian exports have provided upward buoyancy to the AUD and will continue to provide upward support. In normal cases, an appreciating currency depresses exports; Australia is different. Its top four exports currently are coal, iron ore, gold, and petroleum oils, in that order — all commodities that

have become fairly bulletproof. Coal exports from Australia will continue to increase as long as oil prices are high. Chinese steel producers recently accepted an 85 percent increase in the price of iron ore — Australia stands to benefit enormously because its iron ore is of the highest quality.

### Australian Inflation Rate



Source: Bloomberg

In the near term, real GDP growth will likely slow down — not a terribly bad thing since Australia has had positive economic growth for the past 16 years and the slowdown will give it a chance to fight the inflation bug. This slowdown will happen if inflation rates go up, which is likely given global inflation rates are on the rise, fueled by rising commodity prices. Increased money inflows because of the rise in iron-ore prices and stimulatory tax cuts amounting to AUD 7 billion (due to go into effect on July 1) will also add to the inflationary pressure. The rise in pressure will put the Australian central bank, the Reserve Bank of Australia, in a bit of a conundrum. Normally, when inflation rates are up, the bets are on the central bank raising rates. However, in this case, the central bank is likely to keep the status quo on interest rates in the near future because of bad news in the economy: There was an unexpected drop in employment in May 2008, the first such drop since October 2006, and the business confidence index in May was below zero, its fifth straight month below zero. It also doesn't help that inflation rates are only released on a quarterly basis, making it harder to gauge inflation. That said, if the inflation rate for the second quarter rises unacceptably, the Reserve Bank of Australia will have no other option but to raise rates, though probably by only 25 basis points.

## CHINA

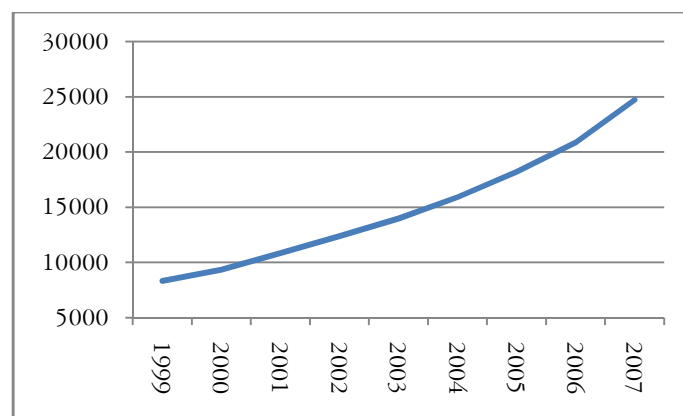
Two issues have dominated conversations of the Chinese economy in the past few weeks: inflation and fuel prices. Though fuel prices almost always affect inflation, their relationship so far has been different in China. Fixed (subsidized) prices of fuel ensured that the high global prices of oil only had a minimal impact on the inflation rate. However, that will change now because of increased fuel prices. The increase of fuel prices, by as much as 18 percent on June 20, is going to keep the upward pressure on the inflation rate. China's average inflation rate from January to May 2008 is over an uncomfortable 8 percent: most of inflation has been driven by rising food prices. Apart from the direct effect of increased fuel prices on the inflation rate, there is likely going to be an indirect effect; a large percentage of fuel in China is consumed by freight and this will further negatively impact the inflation rate. Going forward, food and fuel prices are likely going to be the main drivers of higher inflation in China. Increased capital flows into the country aren't helping the cause — foreign exchange reserves at the end of April were around USD 1.76 trillion and reports suggest that China is accumulating reserves at the rate of USD 100 million per hour.

As a response to this overheating, and to the higher-than-expected GDP growth rates in the first quarter of 2008 (a spectacular 10.6 percent, slight down from 11.2 percent in the previous quarter), the People's Bank of China, China's central bank, has been raising the reserve ratio of banks. On June 10, the central bank hiked the reserve ratio, the fifth time this year, by one percentage point to 17.5 percent (effective June 25). However, during this period of relatively high inflation, the central bank has not raised its benchmark lending rate, currently at 7.47 percent and constant since December 21, 2007 when it was raised 18 basis points. The central bank's hand may be tied in this matter. Since the Chinese yuan is a managed currency, any rise in rates could contribute to upward pressure on the currency. The yuan has appreciated almost 17 percent from its fixed-rate days, and 6 percent this calendar year. This appreciation may be higher than desired by the authorities but the weakening U.S. dollar gave them no choice.

The near-term outlook for interest rates is that they will go up. The current lending rates have been

below the inflation rate since February 2008 — this is not a desirable situation, especially when the government is trying to cool down the economy. Simultaneously, the government is likely to increase the band around which the yuan moves — meaning it will let the yuan appreciate. These two moves will have the effect of slowing down inflation. The former will reduce inflation expectations and possibly put a dampener on wage inflation, something that has been rising at a very fast pace. The latter will have the effect of reducing import prices, particularly those of oil. An appreciated yuan may have a deleterious effect on exporters, but it will increase domestic consumption and provide a counterbalance. That said, any move will likely come after the conclusion of the Beijing Olympics.

### Average Wages in China (Yuan)



Source: Bloomberg

## INDIA

In India, only one issue has dominated conversation since March: inflation. After several months of relatively benignity, inflation reared its ugly head in March 2008 and has since been on an upward trend, culminating in an inflation rate of 11.42 percent in the second week of June, up from 11.05 percent week before (India's inflation number is released on a weekly basis). A higher-than-expected GDP growth rate of 8.8 percent in the last quarter of FY08 (India's fiscal year is April to March) also contributed to the overheating pressure. The sudden increase to 11.05 percent (it was 8.75 percent the previous week) was expected since it was then the government increased the prices of fuel products.

India's central bank, the Reserve Bank of India (RBI) has responded using its two tools, the benchmark lending rate (repo rate) and the cash reserve ratio (CRR). The RBI increased the repo rate twice, once by 25 basis points to 8 percent and then by 50 basis points to 8.5 percent (the last increase came into effect on June 25). The RBI has increased the ratio of cash that banks have to keep as a percentage of deposits from 7.5 percent to 8.75 (it becomes 8.5 on July 5 and 8.75 on July 19).

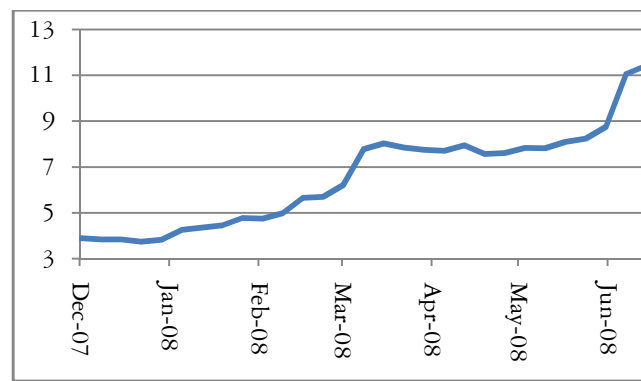
It is very likely that inflation will be on the higher side in the coming months, somewhere above 10 percent — the RBI's preferred upper limit is 5 percent. In response to combating this inflation, the central bank will likely raise interest rates by another 25 to 50 basis points this year and also increase the CRR. It should be noted that the RBI, given a choice, prefers hiking the CRR because of the fact that monetary policy is still more of an art than a science — monetary policy has a long impact lag and the impact of higher interest rates could hit when the economy is slowing, to devastating effect. However, they will be forced to raise interest rates to dispel incipient inflationary expectations. As a result of the global meltdown in the stock markets as well as increased inflation, many foreign institutional investors have left India.

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## Vietnam's economy has been growing at a spectacular pace to say the least. While bigger countries like China and India were out in the front, Vietnam grew at a rapid pace away from the limelight.

This has put enormous downward pressure on the Indian rupee; it has lost close to 8 percent in 2008, making it one of the worst performers in the region. Given India's ever-widening current account deficit, a result of its high oil imports, the rupee looks set to depreciate even further, possibly to the 44 levels. Oil imports are higher than what they would be (in an economic equilibrium sense) because subsidized fuel prices encourage people to consume more than they normally would. There has been speculation that the RBI would like to strengthen the rupee in order to negate the effects of rising commodity prices. This will likely be a battle that the RBI will lose. GDP growth in the near term will also slow as a result of inflation and consequent monetary actions.

### Inflation Rate in India (% YoY)



Source: Bloomberg

Note: India's inflation rate is released on a weekly basis.

### VIETNAM

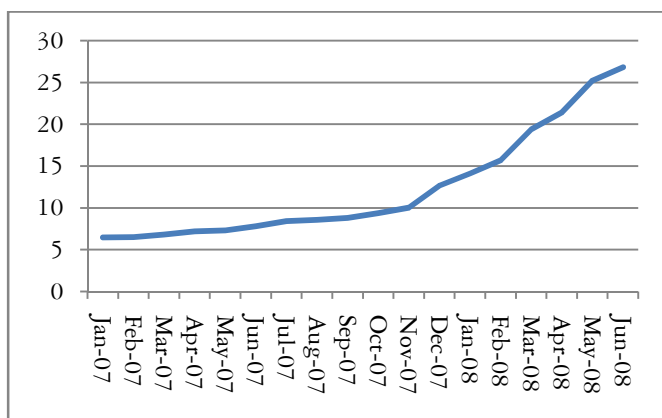
Vietnam's economy has been growing at a spectacular pace to say the least. While bigger countries like China and India were out in the front, Vietnam grew at a rapid pace away from the limelight. Its average quarterly GDP growth rate from the first quarter of 2001 to the first quarter of 2008 was a spectacular 7.4 percent, a feat managed by very few economies. However, this has come at a very high price. The economy has completely overheated and has blown many gaskets along the way. The inflation rate in June 2008 was 26.8 percent, up from 25.2 percent in

May, and 7.31 percent in May 2007. The currency, the Vietnamese dong, has also started to depreciate against the U.S. dollar but it's been a fairly controlled depreciation — the dong has only depreciated by around 4 percent since the start of the year. The benchmark interest rate is currently 14 percent: it was hiked by 2 percentage points in June 2008 and 3.25 percentage points in late May.

The outlook for Vietnam is not a good one, at least in the near-term. A possible cause for overheating, along with other reasons, is that the central bank did not raise interest rates when higher inflation trends were noticed in the economy. Inflation in Vietnam has been on an upward trend since mid 2007 and for a number of months, the inflation rate has been well above the benchmark interest rate — the current gap

is a staggering 11 percent. To combat this inflation, which will mostly stay at high levels during the coming months, the authorities have clamped down on building projects as well as bank lending. The government has also responded by imposing price controls on a number of items — a move that will only guarantee increased pain in the coming months and years. It remains to be seen how these measures will play out in the long-run but on the face of it, it seems like the authorities can do more to quell inflation as well as inflationary expectations. It is virtually guaranteed that the central bank will raise rates by a few percentage points very soon but they won't increase it dramatically for fear of hurting the domestic economy: a valid concern. The other problem with raising rates too quickly is that it may further increase the non-performing loans of state banks and also put increased pressure on state-owned enterprises some of whom are large employers.

### Vietnamese Inflation Rate



Source: Bloomberg

As far as the currency is concerned, fears of an Asian currency crisis kind of withdrawal are a bit overblown. That said, the Vietnamese dong is headed downwards for two reasons; one its current-account deficit is widening and two, foreign institutional investors are moving a lot of their money out of the country. The central bank devalued the currency by 2 percent in June but that may not be the end of the story. Forward contracts of the dong point to a drop of close to 33 percent. A devalued dong will only add fuel to the inflationary fires.

GDP growth rates are going to slow; optimistic growth forecasts say 7 percent but GDP growth will likely be lower. GDP growth rates may also get hit

by a negative consumption effect: the result of reduced purchasing power as well as a drop of close to 60 percent in the stock market, a market that is unlikely to recover anytime soon. ●

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