



# Asia Pacific economic outlook

August 2008



A Deloitte Research Report

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

- The Asian Development Bank (ADB) says that Asia is “behind the curve” in curbing inflation — benchmark interest rates in some countries are below their inflation rates.
- The ADB predicts that developing countries in Asia will grow at their slowest pace in 5 years — the U.S. slowdown and high inflation are largely to blame.
- Chinese second-quarter GDP growth ‘slowed down’ to 10.1 percent from 10.6 percent the quarter before — the result of an export slowdown and higher inflation numbers.
- The Bank of Japan expects GDP growth to “to grow at a slower pace for the time being” — it revised its 2008 GDP growth forecast to 1.2 percent from 1.5 percent.
- The Reserve Bank of India is taking inflation head-on — it raised benchmark interest rates by 50 basis points and cash reserve ratios of banks by 25 basis points.
- Vietnam raised its fuel prices by 31 percent — a measure guaranteed to ‘fuel’ its already burgeoning inflation numbers.

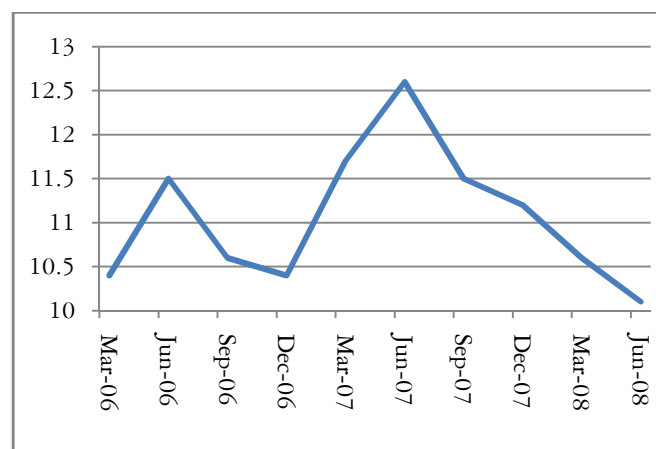
## Outlook for Select Asia Pacific Economies

### CHINA

During the past two decades, China’s growth story has been nothing short of extraordinary. When its 2008 second-quarter GDP growth rate number came in at 10.1 percent, newspaper headlines said that the Chinese economy had slowed down; it was 10.6 percent in the previous quarter. One of the reasons for this slowdown was higher inflation. In June, inflation was 7.1 percent, but it actually reduced from 7.7 percent in May and 8.5 percent in April, perhaps convincing the central bank that its measures of increasing the reserve ratios of banks are working. However, worryingly for the authorities, inflation was higher in rural areas than in urban areas. The yuan has appreciated by around 5.8 percent so far this year. While the strengthening yuan could be helping to reduce inflation, it is also creating a problem for exporters who are already faced with problems of high wages and increased raw material prices.

The Chinese Politburo, in a meeting held late July, said China’s focus will be on “ensuring steady and fast economic growth and controlling excessively rapid price increases as the key tasks of its macroeconomic policies”. This statement was quite obviously a result of the recent slowdown. The central bank’s second-quarter monetary policy report released a couple of days after the politburo meeting has, not entirely surprisingly, indicated that its monetary policy will be focused on creating steady and rapid economic growth. Analysts highlight two notable things missing in this report that were highlighted in previous reports, one was on the monetary tightening that it was doing and the other was on letting the market play a greater role in setting the value of the yuan.

### Chinese GDP Growth Rate



Source: Bloomberg

This could likely mean that the central bank will limit the appreciation of the yuan: a cheap yuan has long been considered a cornerstone of Chinese economic growth. Before, the politburo and central bank announcement, currency forwards pointed to a 10 percent appreciation next year; they now point to a much reduced appreciation. Indications that the government may be opting for a very limited and controlled appreciation include the sudden aggressive measures announced in July to tackle ‘hot’ money inflows. China faces a problem of speculators bringing in money and hoping to gain from the yuan’s appreciation. Such inflows cause unwanted upward pressure on the yuan as well as adding to inflationary pressure. The central bank is now also focusing on money brought in by exporters who rampantly over-invoice and bring more foreign currency into the system. Until now, authorities tended to ignore these inflows and focus more on

portfolio inflows. In another move — this is an odd one — the government is telling foreign investors that they are paying too much for Chinese companies.

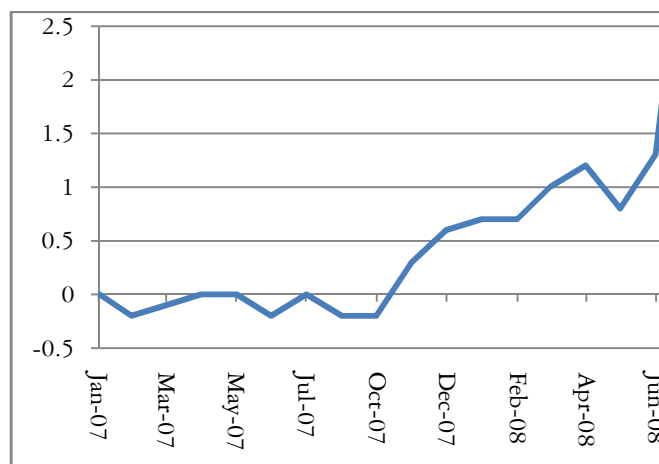
The central bank has thus far feared that increasing interest rates could bring in more inflows and its related problems but the raft of measures announced could likely mean that this may not happen. The central bank's inflation target is 4.8 percent and it could likely raise rates, though minimally, to curb inflation and inflationary expectations. Their only option at this point, if they want contain inflation, is to raise interest rates because raising reserve ratios of banks looks to be a bit overdone. There is always the fear that raising rates may slow down the economy but there are indications that the government is getting ready to pump-prime (increased government spending) the economy to counteract this.

## JAPAN

July has not provided good news for the Japanese economy, and the coming months are likely to follow that trend. The Bank of Japan (BOJ) started its July 2008 edition of the 'Monthly Report of Recent Economic and Financial Developments' by saying that "Japan's economic growth is slowing further, mainly due to the effects of high energy and

performance, fell to -7 in June 2008 from -4 in March 2008. The yen has averaged around 105 to the U.S. dollar since the start of April 2008.

## Consumer Price Inflation (% YoY)



Source: Bloomberg

The near-term outlook for inflation in Japan is that it will likely remain at current high levels. The recent bout of inflation has been almost driven entirely by energy prices and which continues to remain fairly high. The BOJ's monetary policy committee's comfort zone is between 0 and 2 percent and if inflation goes higher than 2 percent in the next few

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materials prices." It then cut its 2008 GDP forecast from 1.5 percent to 1.2 percent while the Cabinet Office, the government's think-tank, reduced its 2008 GDP forecast from 2 percent to 1.3 percent because of high oil prices and reduced U.S. demand — certainly not good news for an economy that has been trying to shake off its lethargy for years. June's headline inflation number came in at 2 percent, its highest level in more than 10 years, while it was 1.3 percent in May. In its monetary policy meeting held in July, the BOJ decided to leave its benchmark interest rate unchanged at 0.5 percent, a rate that has been constant since early 2007 when the BOJ raised rates by 25 basis points. Industrial production in May fell to 1.1 percent from 1.9 percent a month before on the back of weak machinery orders. The Tankan Survey for all industries, a BOJ quarterly survey on business sentiments and business

months it will prove to be an interesting conundrum for the BOJ, which has a very uneasy relationship with its interest rate. The BOJ is, to a certain extent, still haunted by the interest rate increase of 25 basis points to 0.25 percent in August 2000 which crushed an incipient recovery of the economy. Even if the inflation rate crosses 2 percent, the BOJ is very unlikely to raise its benchmark interest rate from its current level of 0.5 percent in the near- to medium-term because of the predicted slowdown in the economy, something that the BOJ isn't really keen to exacerbate. The other reason why the BOJ will keep interest rates on an even keel is because of its own forecast of the Tankan Survey; the survey number is expected to fall to -12 in September 2008. In the near-term, the yen will likely be in the same range as it has been in the past few months.

## MALAYSIA

Like other countries in the region, the news coming from the Malaysian economy is not that promising. The inflation bug has finally hit Malaysia; in June, inflation grew by 7.7 percent a 27 year high! This compares to an average inflation rate of 2.32 percent in the previous 12 months. However, the rise in inflation was not a surprise. In June, Prime Minister Badawi, decided to remove fuel subsidies that were draining the exchequer and creating a fairly massive hole in the budget; petrol (gasoline) prices increased by 41 percent, while diesel went up by 63 percent. This rise in fuel prices had the effect of increasing food and transportation prices. However, the inflation growth rate was not expected to be that high: most economists were expecting the inflation rate to be somewhere between 6 and 7 percent. Other macroeconomic indicators remain fairly solid with

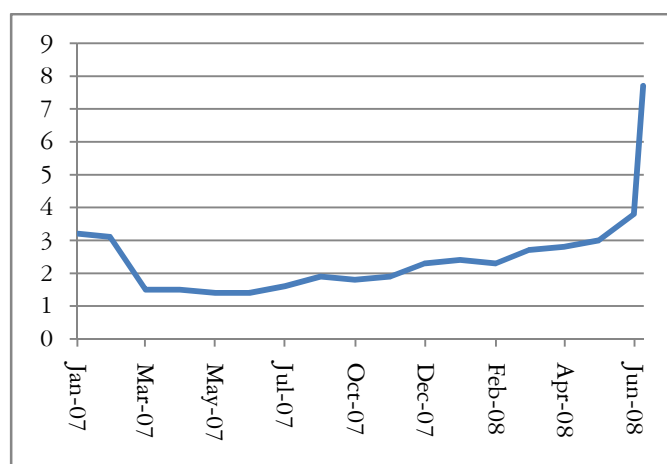
expecting a rise in interest rates when the BNMs monetary policy committee met in July but the BNM kept its benchmark rate constant. BNMs policy is very unclear but it's likely that they are waiting to see if commodity prices will fall further than what they've fallen in the latter half of July. BNM Governor Zeti Akhtar Aziz said that the central bank will look at the risk to economic growth before deciding on rate hikes. He also said that the exchange rate isn't a policy tool — a statement that that should be taken with caution given Malaysia's long record of managing their exchange rate .

Like China and a number of other Asian countries, monetary policy in Malaysia plays second fiddle to its exchange rate policy, but it does not have the excess liquidity issues that are plaguing China. Malaysia will continue to ensure that its currency does not appreciate too much where it could hurt exporters; an

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only the leading indicator of growth showing a slight dip, but the general trend is upward. The ringgit has weakened slightly in the past few months on inflation concerns.

### Consumer Price Inflation (% YoY)



Source: Bloomberg

The benchmark interest rate is currently at 3.5 percent, and the central bank, Bank Negara Malaysia (BNM), has not changed the interest rate in the past two years because the inflation rate was rather benign until June's number came out. The market was fully

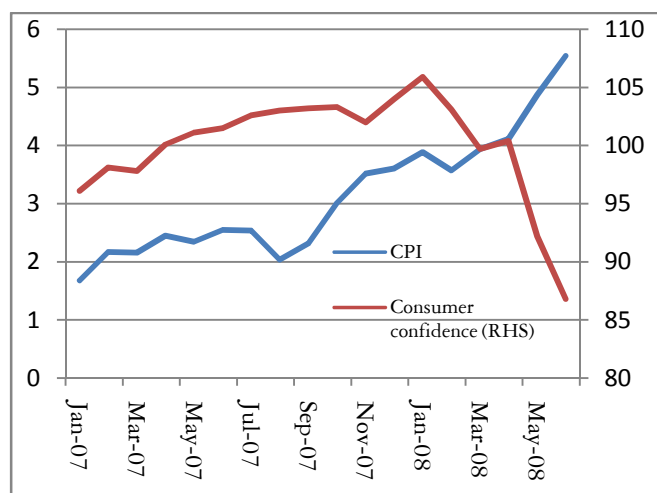
obvious source of appreciate pressure is an interest rate hike. That said, Malaysia's central bank isn't yet caught between a rock and a hard place like other Asian central banks. This could change if inflation persists as expected. If inflation continues to remain high, the BNM will be forced to re-examine its exchange rate policy, which could likely result in a much stronger ringgit as well as higher interest rates.

## SOUTH KOREA

Like pretty much every country in Asia, South Korea too is going through rough times. Second quarter GDP grew by 4.8 percent YoY on the back of exports, but the future doesn't look all that bright. Headline CPI grew by 5.54 percent while core-CPI grew by 4.31 percent in June, reaching its highest level in 9 years. South Korea's central bank left its benchmark rate — the seven-day repurchase rate — constant at 5 percent, where it's remained since August 2007 when it increased by 25 basis points. The business survey on manufacturing confidence is on a downward trend. The latest number is 85.7, and any number below 100 suggests a pessimistic mood for the next month. Similarly, the consumer confidence number released in June was 86.8. Like the previous number, anything below 100 means a

thumbs-down; the bigger problem for South Korea is that this is a 6-month leading indicator.

### Consumer Price Inflation (% YoY) and Consumer Confidence



Source: Bloomberg

The near-term outlook for Korea points to a strong likelihood of an increase in the central bank's benchmark interest rate in August, given the high inflation numbers and the likelihood that they'll want to crush inflation before it does any real damage to the economy. Lee Seong Tae, the governor of the central bank, thinks that inflation may remain high for awhile, and this increases the likelihood of action from central bank. This may weaken domestic demand, but the central bank would prefer to get rid inflation now rather than later.

During last year's presidential election, President Lee Myung Bak won on a promise to boost economic growth to at least 7 percent. As a result, the government let the Korean won depreciate quite heavily so that South Korea would become competitive in world markets it has depreciated by over 8 percent in 2008. While the level of exports is certainly going up as a result of the cheap currency policy, an unwelcome import is inflation through high commodity prices. After recent port strikes on the inflation issue, the government seems to have changed its focus to tackling inflation rather than promoting growth. It cut its own 2008 growth forecast to 4.7 percent from 6 percent. The won has also gained value towards the end of July because of speculation that the government will prop up the currency. The government denies such actions, but the finance minister said he would only act in a herd

mentality. Since there's seldom smoke without a fire, the currency will likely gain back some of the value it lost in the past few months. GDP growth will likely slow this year because of higher inflation and lower business and consumer confidence.

### About the Economist



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Sunil Rongala is a Manager with Deloitte Research, Deloitte Support Services India Private Limited. He holds a Ph.D. in International Economics from Claremont Graduate University, California and a Post-Graduate Diploma in Economics from the London School of Economics. Prior to joining Deloitte, Sunil was the economist for a large manufacturing conglomerate in India. He recently co-authored a book on Asian macroeconomic issues titled *Asia in the Global Economy: Finance, Trade and Investment*.

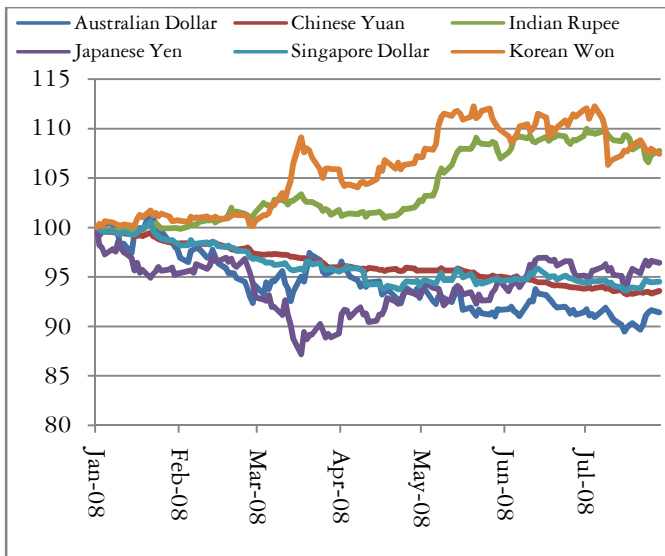
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## Select Economic Indicators

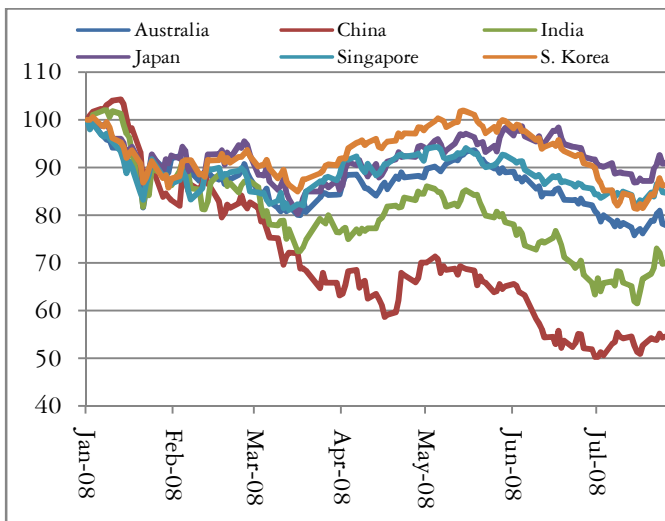
### Indexed Daily Movement of Major Currencies (January 1, 2008 to July 28, 2008)



Note: Above 100 means depreciation and below 100 means appreciation

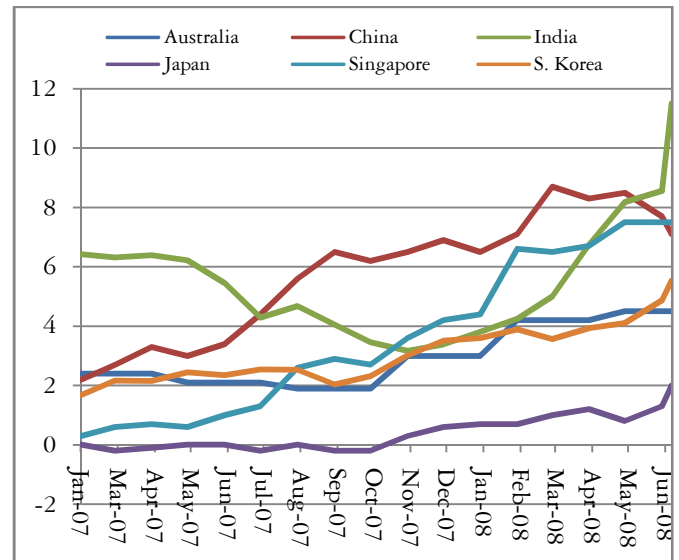
Source: Bloomberg

### Indexed Daily Movement of Major Stock Exchanges (January 1, 2008 to July 28, 2008)



Source: Bloomberg

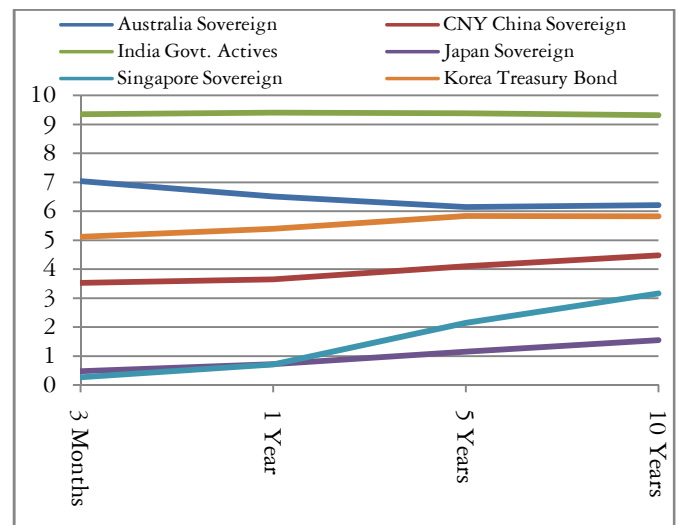
### Inflation Rates



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

Source: Bloomberg

### Yield Curves\*



\* As of July 31, 2008.

Source: Bloomberg

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