



Asia Pacific economic outlook

December 2008



A Deloitte Research Report

Key Takeaways from the IMF's Regional Economic Outlook for the Asia Pacific region

- Asia is being rattled by the crisis as a result of its close trade and financial integration with the rest of the world, and any hope that the region would escape the crisis unscathed has by now evaporated. Looking ahead, the key financial risks for Asia stem from volatile capital flows, tighter external financing, and disruptive spillovers to domestic markets, which could lead to a sharp credit squeeze and slower growth.
- China's growth in 2009 is projected to decline to 8½ percent. With exports likely to fall sharply and the property sector weakening, risks to China's outlook are firmly tilted to the downside.
- Growth in India is expected to decline to around 6¼ percent next year, as tighter financial conditions weigh on domestic activity, particularly investment.
- Growth in ASEAN-5 economies is expected to decline to around 4¼ percent in 2009. Consumption and investment should slow, especially in Vietnam, where monetary tightening has depressed activity.
- For industrial Asia, growth is projected to fall to around 0 percent in 2009 from about 1 percent this year. Growth in Japan is expected to turn negative on account of a contraction in exports and investment while private consumption is likely to stay sluggish in the face of weak confidence and low wage growth. In Australia, growth is slowing below potential because of tighter credit conditions and the easing in commodity prices.

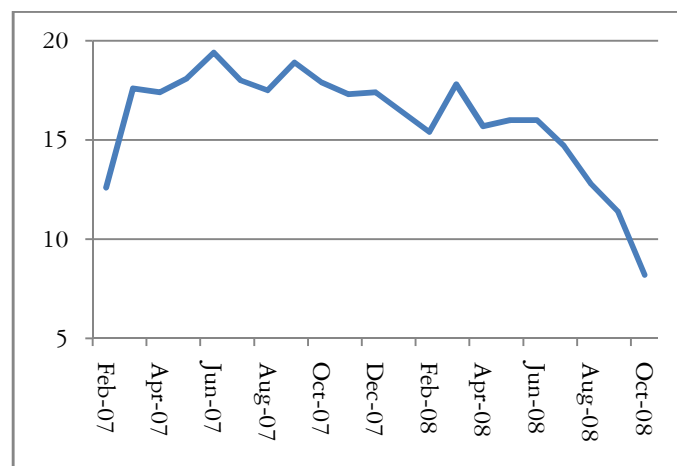
Outlook for Select Asia Pacific Economies

CHINA

China, in the past months, has had some bad news on the economic front. The economy grew by an anemic 9 percent (by China's high standards) during the third-quarter. Industrial production (IP) in October grew by 8.2 percent compared to an average of 15.2 percent in the first nine months of the year. The automobile and steel industry, both of which saw high growth in the past few years have now become flat in the past months. Exports in October were

down by around \$8 billion from the previous month. November's purchasing managers' index for manufacturing was down to 38.8 compared to 44.6 in the month before. The macroeconomic leading index is at a level seen more than 8 years ago. There have been reports of people being laid off from companies and also reports of employees not being paid. The China Association of Small and Medium Enterprises reported that 76000 small and medium-sized enterprises closed down in the first half of the year. However, the number of companies that have ceased to exist because of mergers is not known. However, it is not all bad news. Retail sales growth came in at a solid 22 percent but slightly lower than the previous month's number of 23.2. The consumer price index (CPI) has come down from elevated levels; inflation in October grew at 4 percent compared to 4.6 percent in September and 8.7 percent in February. The producer price index (PPI) is also down from its previously elevated levels. That CPI and PPI are falling is not entirely surprising given lowered energy prices. The value of the yuan against the U.S. dollar has been near constant since July 2008 — exporters were affected by the rising yuan and the central bank (People's Bank of China (PBC)) started intervening in currency markets to prevent any appreciation (the average value was 6.82 between July and November included). Real estate has been badly affected too; the real estate index for the third-quarter is down 21.4 percent YoY while it was down 9.3 percent in the previous quarter.

Industrial Production Growth (% YoY)



Source: Bloomberg

The PBC has been cutting rates fairly aggressively to try and give a boost to the economy. In late October, they cut their benchmark interest rate, the 1 year

lending rate, by 27 basis points to 6.66 percent. However, topping that cut was the one the PBC made on November 26th they cut their benchmark interest rate by a hefty 108 basis points to 5.58 percent. Also lowered were the reserve requirements of big banks from 17 percent to 16 percent and those of small banks fell from 16 percent to 14 percent. The slowing down is also the reason why the Chinese government announced a 2-year, 4 trillion yuan plan (\$586 billion) to boost the economy. The money will be spent on 10 areas including, among others, electricity, water and rural infrastructure.

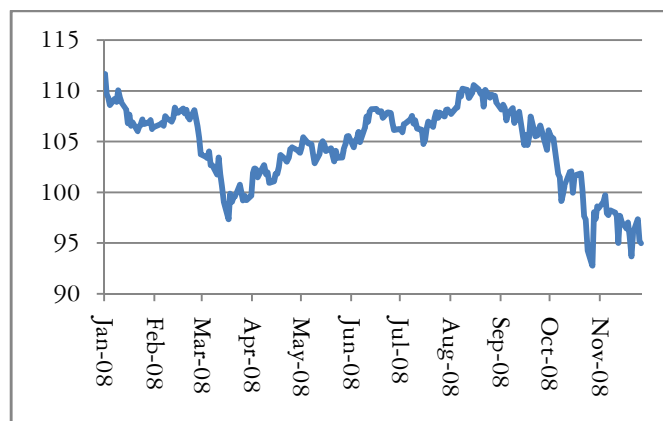
In the near-term, the economy will likely slow even further the big interest rate cut is indicative of that. There have been estimates that fourth-quarter GDP growth could come in as low as 4 -5 percent. The OECD expects that the Chinese economy will grow at 9.5 percent in 2008 and 8 percent in 2009. As economies, especially the U.S., weaken in the coming quarters, export growth is going to be negatively impacted and that means the industrial sector will weaken. The yuan is likely to be around 6.82 or even weaker. Given falling energy prices, the CPI and PPI will likely remain low in the near-term: the fall in PPI will likely provide a boost to the income statements of firms. With the fall in inflation, the central bank will likely cut interest rates (the PCB posted a statement on their website titled “PBC to Implement Moderately Loose Policy to Boost Growth”). The banking sector, most of which is state-owned, may see their bottom-lines negatively impacted because of the lending rate cuts as well as the increased pressure from the government to extend more credit to firms. It is unclear by how much the stimulus plan will boost the economy — a senior Chinese official says 1 percent — but it is clear that it will give a positive boost to the economy.

JAPAN

Japan officially entered into a recession in the third-quarter. GDP growth in the third-quarter was -0.1 percent YoY compared to 0.7 percent positive growth in the previous quarter. This is first time that Japan has seen negative economic growth since the second-quarter of 2002 when growth declined by -0.2 percent. Nearly every sector is seeing a decline. Industrial production in October fell by 7.1 percent compared to a positive growth of 0.2 percent in the previous month. IP also fell in August by 6.9 percent. Retail sales fell by 0.3 percent in September while

nationwide department store sales fell by 6.8 percent. Export growth has been very anemic; it grew by just 2.1 percent though it was a step up from 0.9 percent growth seen in the last quarter. Anemic exports have seen the current account surplus contract by 48.8 percent in September. Machinery orders, an indicator of capital spending in the next three to six months, have been falling continuously in the past few months. Machinery orders tumbled by -4.2 percent in September and -13 percent in August.

Japanese Yen vs. U.S. Dollar



Source: Bloomberg

CPI excluding fresh food for September was fairly high at 2.3 percent but the data indicates that high energy prices, now no longer a concern, contributed to inflation. The Tankan survey forecast for manufacturing companies indicates that the mood among them is dismal. The Economy Watchers survey index which indicates the mood among workers in Japan slumped to 22.6 in October from 28.0 in September. Consumer confidence is also reaching new depths. Bank lending in October grew by 2.5 percent, the fastest rise since August 1992. Bank lending is increasing because banks are hoarding cash and pushing up money market rates and thus preventing companies from issuing fresh debt. The commercial paper market has also frozen for smaller companies because of falling confidence in them and also because the larger companies are crowding them out. This is despite the Bank of Japan (BOJ) cutting its benchmark interest rate, the overnight call rate, to 0.30 percent in late October. 2008 also saw the largest number of bankruptcies among publicly traded firms 30 since World War 2. The yen has appreciated against the U.S. dollar by 17.5 percent since the beginning of the year on account of the unwinding of the yen carry trade.

Going forward, the BOJ is unlikely to reduce its benchmark interest rate unless there is really catastrophic news. It is already at 0.30 percent and is near the liquidity trap, liquidity trap being the point beyond which interest rates cannot be reduced, i.e., 0 percent. The government has announced a \$51 billion stimulus plan but such plans usually work only when consumers increase their consumption. At this point, the numbers indicate that consumers are unlikely to increase their consumption anytime soon. The increasingly tight job market is also going to ensure reduced consumer spending. Machinery orders indicate that there is going to be fall in capital spending in the manufacturing sector and thus a slowdown in production. Exports are also going to suffer because of the global slowdown and more importantly, the slowdown in China which is its largest customer. All these factors will likely ensure that the economy will contract in 2008 and 2009 — the government downgraded its assessment of economic growth by 6 times this year.

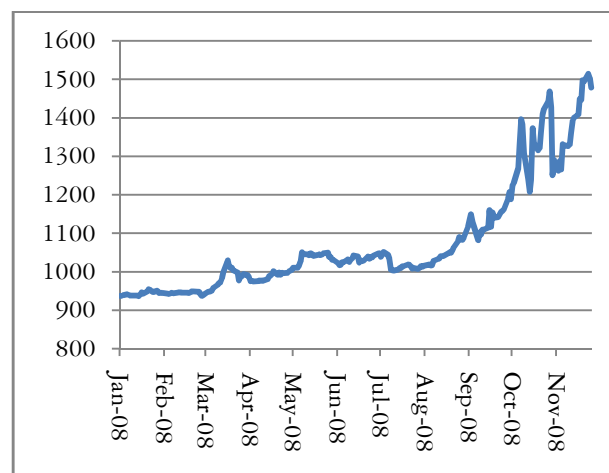
Given the fall in prices, it is likely that Japan will face deflation in 2009 especially in months when inflation was high in 2008. However, this deflation will be different and less worrisome than the deflation it faced in the 1990s because this time it is being caused by unwinding energy prices. The yen is likely to remain at around current levels as it faces sustained unwinding of the yen-carry trade.

SOUTH KOREA

The Bank of Korea (BOK), South Korea’s central bank, cut their benchmark interest rate, the base rate, by 25 basis points to 4 percent on November 7th. In the monetary policy decision statement they said: “The domestic economic slowdown persists. The pace of export growth has declined owing to the weakening of global economic growth and domestic demand such as private consumption remains sluggish. The downside risk to economic growth is considered to have been augmented by the knock-on effects of the financial market unrest.” The interest rate cut was the third one in less than a month; the BOK cut the base rate by 25 basis points to 5 percent on October 9th and by 75 basis points on October 27th by 75 basis points to 4.25 percent. Any time a central bank cuts rates that frequently it can only mean that there are some challenges in the economy.

The economy grew by 3.9 percent in the third-quarter compared to 4.8 percent in the previous quarter and 5.8 percent in the first-quarter. A fall in private consumption and reduced exports led to slower growth. Exports in November fell by 18.3 percent YoY. They grew by 8.5 percent in October and 28.19 percent in September. The Korean won has depreciated sharply in the past few months. Between August 1st and November 26th, it fell by 45.7 percent, second only after the Icelandic Krona. The stock market is down 44 percent year-to-date. Industrial production growth has been quite anemic; it grew by 6.8 percent in September though it was up from the previous month when it grew by 1.8 percent. Korean manufacturer sentiment is at a ten-year low. Retail sales increased 4.6 percent in September compared to 10.4 percent in the previous month. Foreign reserves are down sharply — it was \$212.2 billion at the end of October compared to 258.2 billion in May. The slide in reserves is partly because the BOK has used it to defend the fall in the won and partly because there has been significant capital flight. The BOK, as a result of capital flight, has been forced to conclude swap arrangements with several central banks. Inflation (CPI) has been falling the past months, it was 4.81 in October compared to 5.10 in September but it was 3.89 in January. The composite business survey index has fallen sharply; it was 63.7 in November compared to 103 in January and 84.9 in October.

Korean Won vs. U.S. Dollar



Source: Bloomberg

Going forward, along with most countries in the region the Korean economy is expected to slow and is expected to grow at around 3.5-4 percent in 2008 compared to 5.1 percent in 2007. The OECD

estimates that it will grow at 2.7 percent in 2009 while some investment banks expect the economy to grow anywhere between 2.5 - 3 percent. The government has announced a 14 trillion won (\$10.8 billion) fiscal stimulus package in the form of infrastructure spending and tax benefits but it is likely that this stimulus may not be enough to counter the global economic slowdown.

Manufacturing is likely to slowdown in the near future; a BOK survey forecasts a major dip in manufacturing in the coming months. Post the November 7th rate cut, BOK Governor Lee Seong Tae indicated that he will act again to prevent the economy going into a recession. Given the dismal economic forecasts, the interest rate is most likely going to come down it is expected to come down to 3 percent by the middle of 2009. Falling inflation rates also helps the case for reduced interest rates. In the near-term, the won is likely to remain at around current levels or even strengthen a bit because the fall in the won appears to be overdone. However, the likely fall in interest rates could mean that the appreciation in the won will be limited.

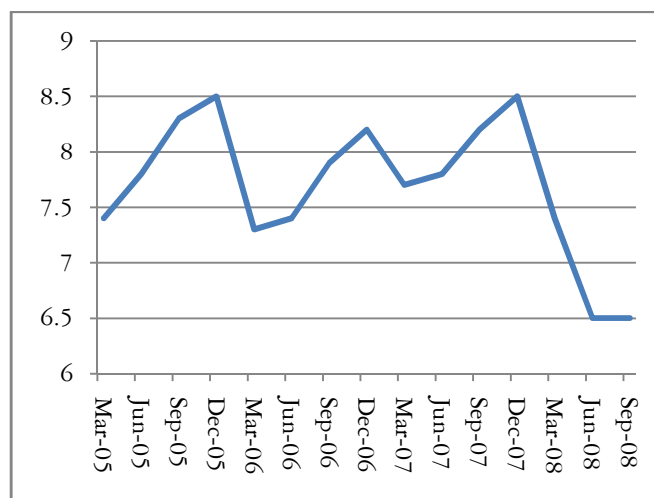
VIETNAM

On December 2nd, the State Bank of Vietnam (SBV), Vietnam's central bank, cut its benchmark interest rate, the base rate, by 1 percentage point to 10 percent. The cut was the fourth such cut in six weeks. The previous three cuts were also one percentage point each the base rate came down from 14 percent to 11 percent within a month. On December 2nd, the SBV also cut the refinancing rate to 11 percent from 12 percent, and the discount rate to 9 percent from 10 percent. The SBV has been cutting rates heavily for two reasons: one, the economy is expected to slow down and two, Vietnamese firms have been complaining about the high interest rates, the second highest benchmark rate in Asia after Pakistan.

Economic growth has been slowing down; GDP grew at 6.5 percent in the third-quarter compared to 7.4 percent in the first-quarter (it grew at 6.5 percent in the second quarter. Industrial production however grew at a robust 15.8 percent in October: however, the trend in IP growth appears to be downward sloping. Inflation is still uncomfortably high it was 24.22 percent in November though it is slightly down from October's number of 26.7 percent. Unlike other currencies in the region, the Vietnamese dong

appears to be fairly stable; it has depreciated only 6 percent year-to-date. Retail sales grew by a healthy 30.7 percent in October, the highest in 6 months.

GDP Growth Rate (% YoY)



Source: Bloomberg

That said, though the macroeconomic numbers suggest that the economy is humming along just fine, the interest rate cuts and the statements by government officials seem to suggest that there may be challenges ahead. The government has set a GDP growth target of 6.7 percent in 2008 and 6.5 percent in 2009 (the economy grew at 8.5 percent in 2007). However, most independent analysts think that the 2009 target is a bit too optimistic. Their range of forecasts are anywhere between 4.5 and 5.5 percent. The SBV is likely to cut interest rates by 1-2 percent before the end of year and the expectation is that they will continue to cut rates into the next year. However, inflation rates continue to be well above comfort levels and any cuts may be incumbent on inflation levels coming down to more reasonable levels. The data suggests that inflation in Vietnam is demand-pull inflation and this means that the fall in energy prices may not put as big a dent in inflation as hoped.

The government is likely to also introduce measures to boost the economy. In late October, Prime Minister Nguyen Tan Dung introduced five measures that he said needed to be taken to prevent economic recession. These five measures are: promotion of production and export, stimulus of investment and consumption, highly flexible financial and monetary policy, improved social protection, and dynamic and flexible guidance and management. However, no details have been released

on this plan though the SBV is diligently following a 'flexible' monetary policy. The dong is likely to depreciate in the near-term. The central bank has widened the band in which the dong can be traded from 2 to 3 percent. The SBV said that the increased band will mean "exchange rates that are closer to supply and demand in the currency market" and this likely means that the central bank is trying to get the currency to depreciate. The depreciation of the dong is an effort by the central bank to narrow the trade deficit by boosting exports. There could likely be consolidation in the banking sector. According to a report done by a banking group, there are over 80 banks in Vietnam (too many according to the report) and 25 percent of lenders are undercapitalized and this may spark a crisis of confidence in the banking system. If consolidation is not done soon, it could spark a crisis because lending growth has decelerated to uncomfortably low levels and those that will be hit the hardest are the undercapitalized ones. ■

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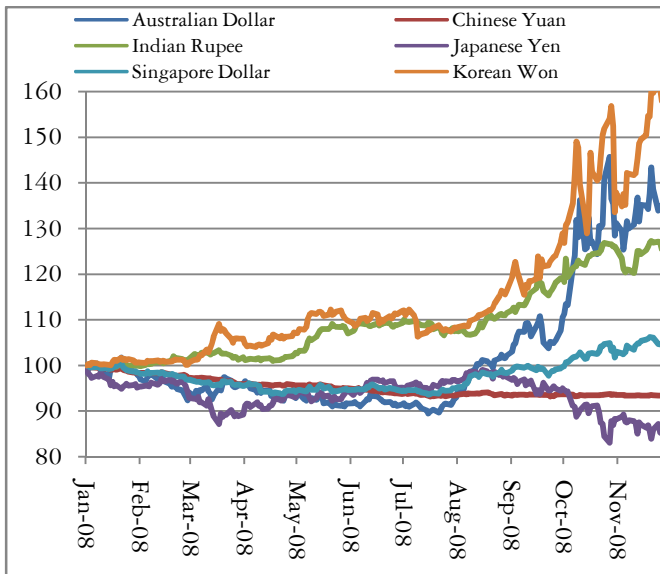
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Select Economic Indicators

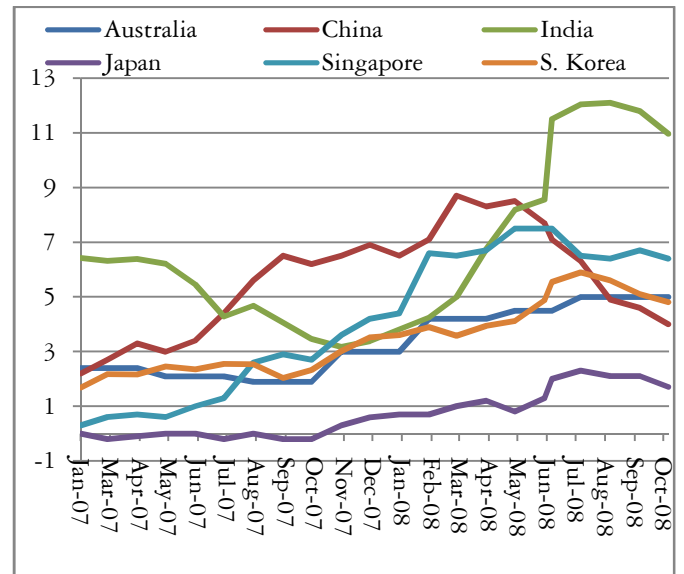
Indexed Daily Movement of Major Currencies (Jan 1, 2008 to Nov 28, 2008)



Source: Bloomberg

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

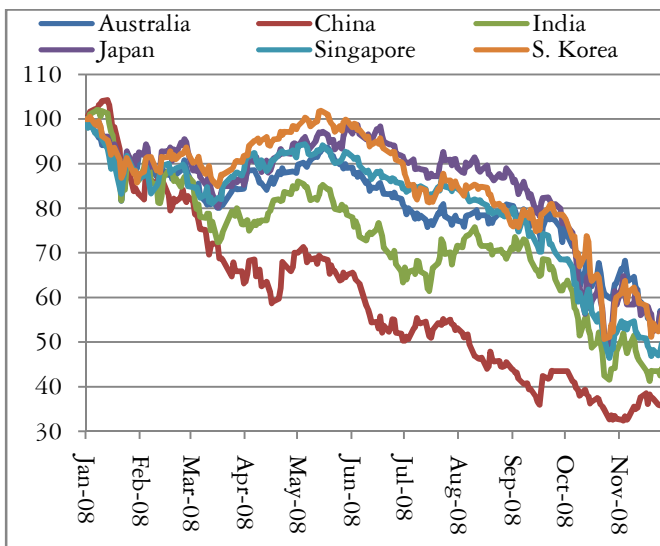
Inflation Rates



Source: Bloomberg

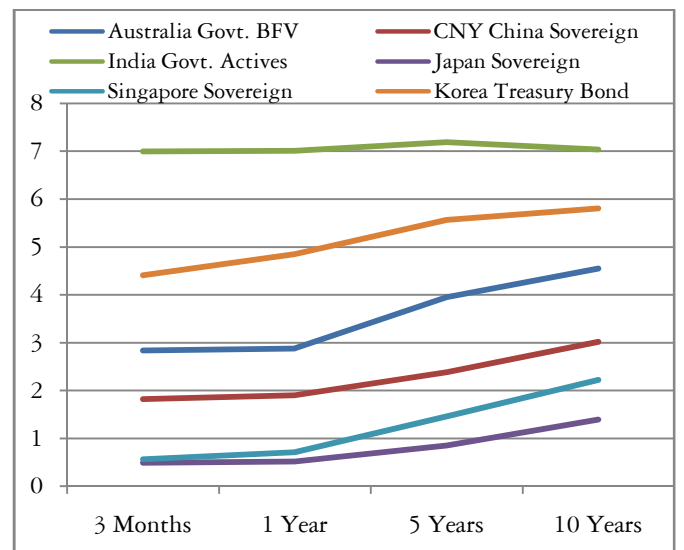
Note: Australia's inflation rate is a quarterly rate. India's is a weekly rate that is averaged.

Indexed Daily Movement of Major Stock Exchanges (Jan 1, 2008 to Nov 28, 2008)



Source: Bloomberg

Yield Curves*



Source: Bloomberg

* As of December 1, 2008.

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