

Voice of Asia

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Our *Voice of Asia* series brings to life the challenges and opportunities facing the region today and tomorrow. *Voice of Asia* is the result of significant collaboration across the Deloitte Asia Pacific and global network.

Three reasons why Asia will experience stronger-than-expected growth in 2018

2017 gave us a lesson in looking beyond the hype. On the surface, it had the appearance of a difficult and tension-filled year, with political divisions deepening and significant shifts to the right in the United States and United Kingdom just beginning to play out. In many ways it was challenging, but that was only one side of the story.

Underneath all the bluster, the global economy was quietly recovering. Now, as we look at what's ahead for 2018, that recovery has become the focus. For the first time in a decade, the major world economies are operating in sync and markets are confident. But is that the full story? In this edition of *Voice of Asia*, we are again looking beyond the headlines, at what 2018 will likely hold in store for Asia Pacific economies, and what some of the possible (but unlikely) vulnerabilities may be.

This time last year, in the first edition of the *Voice of Asia* series, we went against the prevailing gloomy mood and lacklustre economic forecasts of the moment to predict that “2017 will be better than you think,” with Asia playing a central role in better-than-expected global growth. At the time, the leading indicators showed signs that global growth would accelerate as economic recovery strengthened around the world. We also believed that China would weather its headwinds and maintain a decent growth trajectory through the year. And so we now look back on 2017, with the majority of the Asian economies having enjoyed stronger-than-expected growth.

A pickup in both domestic demand and export performance in 2017 helped deliver this in the region. Our predictions that global trade would accelerate faster, a more competitive Asia would emerge, and continuing demand from Asia’s consumers would drive intra-Asian trade proved to be close to the mark. What’s ahead for 2018? Let’s dive in.

Following 2017’s upside surprise, many expect growth in the Asia Pacific region to moderate over the next year. However, we are maintaining our optimistic outlook and believe that the economies in Asia will enjoy another year of growth that outpaces these expectations in 2018.

On the one hand...

In our first article, “Strength from within and demand from outside: Asia’s continuing growth opportunity,” we list three key factors that give us reason to believe this.

1. Domestic conditions are well placed to deliver growth.

In much of the region, the initial drag from recent major policy reforms are fading. The effects of initiatives like the introduction of goods and services taxes (India and Malaysia) and the removal of fuel and other subsidies (Indonesia) hurt consumer confidence, but that effect is wearing off, as are the effects of India’s demonetisation policy.

Many countries and territories have also taken steps to improve their business climate, paving the way to more investment opportunities, or have refocused their policy efforts towards attracting investment. For example, both India and Indonesia made significant gains in the World Bank’s “Doing Business” ranking.

2. A strong pipeline of infrastructure spending initiatives.

Infrastructure remains a key priority in the region. Several countries are launching ambitious infrastructure building strategies. India has announced, and Thailand and the Philippines are implementing, a series of major transportation projects. The largest infrastructure effort in the region is China’s “Belt and Road Initiative,” aiming to boost productivity and efficiency gains in Asia by improving trade links between Asia and Europe.

These projects will support near-term activity and benefit long-term productivity.

3. Continued recovery in global demand providing greater impetus to the trade-driven economies of the region.

There are encouraging signs of a recovery in capital spending worldwide, which has been the missing ingredient in the global recovery so far. Asian export economies stand to be the biggest beneficiaries of this recovery as demand for their exports of manufactured goods grows with increased capital spending in developed economies.

Global financial conditions remain accommodative, capital flows into the emerging market and developing economies have returned, and nonresident capital inflows to the region remain resilient. The global economy seems set for a new investment cycle that will boost the rebound.

...and on the other hand

We are optimistic about the near-term prospects for the Asia Pacific region.

However, if recent economic and geopolitical upsets have taught us anything, it is the importance of considering the “less likely” outcomes. So while we expect positive performance to continue, we also acknowledge ongoing dynamics within some regional economies, and globally, which could create vulnerability for the region.

In our second article, “The flip side: Being aware of what could go wrong in 2018,” we look at some of the potential challenges which could derail progress and growth in the region. At the top of our list of challenges is the build-up of debt from the post-2008 financial crisis period of excess global liquidity. In some instances, such as Australia, China, and South Korea, this debt has been channelled into housing markets, raising concerns of asset price bubbles.

Much attention has been focused on China, with no less than the Chinese central bank governor warning of a potential “Minsky moment,” while the International Monetary Fund has also called on China to boost banks’ capital buffers. So while our baseline scenario is for China to continue its impressive economic performance, there is a risk that financial imbalances which have been building for some time could worsen.

Highly leveraged corporate and household balance sheets have left the non-financial private sector vulnerable to shocks. If left unchecked, a significant negative shock could have far-reaching adverse consequences for economic stability in the region.

In the near term, we believe the likelihood of such a shock is low, but the continued escalation of geopolitical tension will increase this risk. There are threats to the global trade regime that has been so vital to economic development in Asia.

The US administration’s policies towards the World Trade Organisation (WTO) and its approach to existing trade agreements have raised concerns. The decision by the United States to impose heavy tariffs on washing machine and solar panel imports is a sign that the risk is real.

While these measures could end up harming both US consumers and producers in the region, such as in China and South Korea, the real concern is whether this then leads to retaliatory measures. Continued escalation and the threat of a “trade war” could hit global market confidence and devastate the global recovery. More broadly, rising military tensions over North Korea could be the trigger for world risk-off sentiment and form the basis of the reversal of capital flows. An escalation of tensions could rock confidence and be a source of economic instability.

Most likely outcome

While we are conscious of the sources of vulnerability and downside risks, as are policymakers in the region, overall, the balance of evidence suggests that key drivers of growth are in place, and that the strong rebound in global activity in 2017 is set to continue into 2018.

As we approach the Chinese zodiac Year of the Dog in the Asia Pacific region, we say goodbye to the rooster. Those born in the Year of the Rooster are said to be trustworthy, with a strong sense of responsibility at work. Some roosters have been hard at work in the respective administrations of the Asian region, as they reap the benefits of domestic reforms and investments announced and implemented in 2017. Let’s hope for some traits of the dog to continue into administrations this new year—communicative, serious, and responsible—as Asia seeks to consolidate and expand on the good year in 2017.

Strength from within and demand from outside: Asia's continuing growth opportunity

2017 has been quite the year! One year ago, when we launched the first edition of *Voice of Asia*, 2016 had given us an unexpected outcome in the US elections and the Brexit vote. At the beginning of the year, we were heading into unknown territory, unsure of the impact of this geopolitical upheaval and uncertainty on global trade. The headlines were gloomy, and commentators were cautious, making forecasts for 2017 somewhat lacklustre.

When considering the year ahead, we looked beyond the headlines and saw some cause for optimism. We predicted that Asia would outperform the lacklustre economic forecasts of the moment. Now, one year on, we know that a pickup in both domestic demand and export performance in 2017 helped deliver stronger-than-expected growth in the region. In fact, the protectionist rhetoric outside of Asia had a muted impact, as intra-Asian trade increased across the board, with commodity and technology-based exports in particular benefitting from improved global demand.

Now, looking at 2018 politically, uncertainty and caution remain. In fact, we now know the extent of the complexities that Brexit will bring, and have witnessed the tendencies of the US administration to make quick and far-reaching policy decisions. However, we have also had a year where the global economy has thrived, money is cheap, and markets are confident.

Some of the largest economies in Asia have made progress in addressing what have been serious causes for concern. China has taken steps to move away from such a heavy reliance on construction, while actively managing risks in its financial sector, and India has put some key tax reforms in place that will yield long-term gains. Japan has also slowly been addressing fiscal issues and is now well placed to implement real structural reforms. Other Asian economies, to varying degrees, are diversifying, implementing business-friendly policies, and investing in capital deepening. This is due to a combination of domestic factors, low rates, and a strong external environment.

Following this upside surprise of higher growth in Asia in 2017, growth could be expected to moderate over the next year. However, we believe the economies in Asia will enjoy another year of faster growth in 2018. There are three main reasons why:

- **Domestic conditions**, with many economies increasingly benefiting from both their structural reforms and greater stability. Two of the major economies in the region, China and India, successfully navigated some of their key challenges last year and have come out on top.
- **Infrastructure spending**, which remains a key priority in the region and will support both near-term activity and longer-term productivity.
- **Ongoing recovery in global demand** is likely to provide even more impetus to the trade-driven economies of the region.

We believe the economies in Asia will enjoy another year of faster growth in 2018.

Factor 1: Domestic conditions are well placed to deliver growth

A number of economies in Asia, such as India, the Philippines, and Thailand, are experiencing a pickup in domestic demand in the form of consumption.¹

In others, external demand has been a significant contributor to growth, especially in China, Indonesia, and Singapore. Intra-Asian trade continues to be the major driver of export growth, with over half of exports by Asian countries and territories being sold within Asia.² At the same time, inflation has been stable for a sustained period, which will allow monetary policy to continue to support the recovery.

There are two developments in Asian economies that will support growth in the near future:

- Temporary drags which had short-term negative implications for business and consumer sentiment, such as adverse weather conditions and the implementation of economically sensible measures, are dissipating across Southeast Asia.
- Reforms to improve the business climate are already helping to produce a leap in the ease of doing business rankings around the region.

The region is shrugging off past negatives

In recent years, governments across Asia initiated fiscal consolidation programmes to place their long-term fiscal trajectories on a sounder footing. The initially negative effects on consumer confidence hurt growth in the near term, but these effects are now dissipating:

- India's decision to demonetise in November 2016 had a disruptive impact on growth, and cash shortages are likely to still be depressing activity among cash-dependent small businesses and poorer citizens. Nonetheless, the economy may have recovered somewhat from the shock of the suddenly announced initiative, as currency circulation has returned to pre-demonetisation levels. Furthermore, the long-term impacts of moving more of the economy into the financial and tax system will be positive. In the past year, the government implemented the unified Goods and Services Tax (GST), which aimed to provide a fillip to the economy. The short-term impact was marked by a slowdown in growth and suppressed consumer demand. However, market disruptions now seem to be reversing.

- Malaysia implemented a bold new goods and services tax in April 2015 to offset declining oil revenues. It also rationalised fuel and other subsidies, initially giving households a shock. Recent data shows that the Malaysian consumer has now mostly overcome these ill-effects.³
- In Indonesia, lower oil prices afforded the Jokowi administration an opportunity to rationalise fuel subsidies in early 2015. The early impact was to drive up inflation and depress consumer confidence. However, as government revenues were freed and channelled toward such productive activities as infrastructure development and targeted cash handouts, the downside impact has been reversed.⁴

Moreover, between 2013 and 2015, central banks in many parts of the region had also implemented macro-prudential measures to rein in excessive growth in household debt as well as real estate booms that they feared might threaten financial stability over time.⁵ As with the fiscal reforms above, such measures restrained domestic demand for a while, but no longer.

Finally, the collapse in global commodity prices in 2014–2015 also hurt household incomes in the rural sectors in countries such as Indonesia, Thailand, and Malaysia. Bad weather (for example, El Nino) in 2016 had also decimated agricultural exports in Malaysia, with palm oil being the main casualty as plantations were scorched.⁶ Elsewhere, Thailand had to contend with rural droughts over the past few years which had an adverse impact on crop yields.⁷ In India, overproduction and demonetisation also hurt farm incomes. Now, we find commodity prices stabilising and farm incomes in particular bouncing back, giving a boost to domestic demand.

Reforms are adding up, improving the business climate and thus boosting investment

In China, businesses have increased leverage as government encouraged spending and investment in heavy industry to boost economic growth. However, this resulted in significant overcapacity in the industrial sectors and increased financial sector risks. Chinese authorities have been progressing domestic reform to reduce this overcapacity, and so far the tightening measures in credit markets have had a generally muted impact on economic activity.⁸

Meanwhile, the Indian government has made huge strides towards financial inclusion by implementing the JAM trinity (Jan-Dhan Yojana, Aadhaar linkage and Mobile Subscription), which facilitates the delivery of services and transfer of government benefits to more than one billion citizens. Coupled with the demonetisation in late 2016 and Goods and Services Tax reforms over the last year, India is steadily moving towards a greater formalisation of the informal economy. More broadly, there was a significant improvement in the local business climate, with India jumping 30 places in one year to no. 100 in the World Bank's "Doing Business" ranking.⁹

There has also been progress on the fiscal front as governments take advantage of stronger economic conditions to implement difficult reforms:

- In Japan, there has been a refocus on the fiscal arrows of Abenomics to lift the Japanese economy from a decade of tepid growth and the threat of deflation. On the agenda is a rise in the consumption tax rate from 8 percent to 10 percent in October 2019. Previously, a rise in the consumption tax has driven the economy into recession. But with conditions proving upbeat, it is likely that the 2019 rise will go ahead. Proceeds from the rise will be funnelled into policies aimed at boosting productivity in the ageing economy, including improved childcare facilities to support women's participation in the workforce.
- To ensure fiscal prudence, the Philippines government is stitching together tax reforms to raise revenues for an infrastructure programme and to keep government finances on solid footing. Personal income tax rates will be slashed (except for high income earners), corporate taxes will be lowered, and other tax provisions will be simplified to improve taxpayer compliance. To offset revenue loss on these fronts, the value-added tax base will be expanded by reducing exemptions. Excise taxes on fuel and levies on sweets will be restructured. The government is also contemplating a tax amnesty programme in 2018 to broaden the tax base and raise tax rates further.

On the other hand, some governments are taking advantage of improved budget positions to boost spending plans and attract foreign investment, a key policy goal across the region to boost economic growth and longer-term productivity gains. Policy can focus on streamlining government processes, reducing corruption and red tape, as well as changing foreign ownership rules.

- A KRW 11 trillion supplementary budget—aimed at boosting job creation, social welfare expansion, and other income-boosting measures for the South Korean people—was approved in early 2017. Ramped-up fiscal spending will lead to increased investment in social infrastructure as well as support for real estate investment as incomes rise.
- The Singapore government aims to attract investment by leveraging its hub status and openness to trade and commerce. In 2017, the Committee on the Future Economy (CFE) unveiled seven strategies to boost competition and ensure the country stays relevant.¹⁰ To support this goal, the government has announced a flurry of measures and initiatives focussed on innovation and digitisation.¹¹
- The Thai government hopes to woo foreign investors to set up manufacturing bases in the region by offering significant external economies of scale for foreign firms to exploit. To complement the manufacturing push, the government has developed Thailand 4.0, a comprehensive plan for the country to pivot towards a knowledge-based economy with emphasis placed on R&D and innovation.¹² To this end, the Thai government has identified 10 target industries for the nation to prioritise which will be the new engines of growth.

Policy can focus on streamlining government processes, reducing corruption and red tape, as well as changing foreign ownership rules.

- In Indonesia the reformist Jokowi administration has pushed ahead in its efforts to improve the business climate to attract foreign investment. Since the start of 2015, Indonesia has been implementing 16 deregulation policy packages to address Indonesia's business environment.¹³ In 2016, President Jokowi signed a regulation on the negative investment list which lists fields of businesses that are open and closed to foreign investment with varying percentages of ownership.¹⁴ These have correspondingly resulted in marked improvements in the macroeconomic environment, financial market development, and innovation, leading to record foreign direct investment (FDI) in the third quarter of 2017 and boosting Indonesia 19 places in the World Bank's "Doing Business" ranking.¹⁵
- The Duterte administration in the Philippines recently instructed the National Economic and Development Authority to relax restrictions on foreign investments in eight areas, including retail trade and maintenance of domestic infrastructure amongst others. A revision to the Foreign Investment Negative List is in the works as the government attempts to open up sectors previously closed to foreign competition and ownership.¹⁶ There are also plans to lower the capital requirement for foreign investors to do business in the country.

Factor 2: A strong pipeline of infrastructure spending initiatives

Governments across the region have embarked on a burst of infrastructure initiatives. Not only will infrastructure projects boost the near-term outlook for economies in the region through higher investment activity, they will also support longer-term growth through an increase in productivity.

The largest infrastructure effort in the Asia Pacific region is China's Belt and Road Initiative. The ambitious project aims to boost productivity and efficiency gains in Asia by improving trade links between Asia and Europe. The project is still in the early stages, but a number of infrastructure deals have already been signed under the initiative. The reach of these initiatives is illustrated by the agreement that the Papua New Guinean government has signed with China, which will deliver infrastructure projects aimed at enhancing agriculture, road, and water supply to rural parts of the country.¹⁷

But it isn't just China that has an ambitious infrastructure program. Various governments across the region have committed large swathes of cash to infrastructure projects, predominantly in the transport space.

- Many state governments in Australia are awash in cash as revenues from stamp duty soared, with house prices rising rapidly over the past year or so, supporting the budget bottom line. This has manifested in a flurry of investment activity, including a number of large transport projects planned in the major eastern states.
- The Indian government has acknowledged the need to bridge the country's infrastructure deficit with greater emphasis on public investment. The Modi government gave the greenlight to an INR 7 trillion infrastructure program in late 2017, with the aim to pave more than 80,000 km of road by March 2022. India has also taken steps to collaborate with international partners to speed up the process of infrastructure building. Specifically, India and Japan have been cooperating on infrastructure development in India's north-eastern states.

Governments across the region have committed large swathes of cash to infrastructure projects, predominantly in the transport space.

- In Indonesia President Jokowi has accelerated government investment in infrastructure—spanning the construction of roads, ports, power plants, and rail transport amongst others—with 37 projects currently in the infrastructure priority list and slated to be completed by 2019.¹⁸ To address the shortfall of funds, given the cap on government spending plans, the Jokowi administration is inviting private-sector involvement from both domestic and foreign investors.
- Further upgrades to pre-existing transport infrastructure are in the works in Singapore, with new and expanded metro lines due to commence operations in the coming years. There is also the Kuala Lumpur-Singapore high-speed rail project,¹⁹ a bilateral initiative between the Singapore and Malaysia governments.

And it's not only transport receiving government funding, with both the Korean and Taiwanese governments expanding their fiscal stimulus packages to include investment in new technology, such as green energy and the adoption of artificial intelligence.

Although public investment is a major driver of growth in 2018, there are also signs that private investment is picking up. In Australia, private capital expenditure grew in year-on-year terms in the third quarter of 2017 for the first time since the end of 2012. Furthermore, the outlook is also positive, with planned capital expenditure picking up in the 2017-18 financial year.

The abundance of public and private investment will create jobs and business opportunities across the region in the short term. Looking longer term, improved connectivity will ease the movement of goods across each economy and support business productivity.

Factor 3: Continued recovery in global demand providing greater impetus to the trade-driven economies of the region

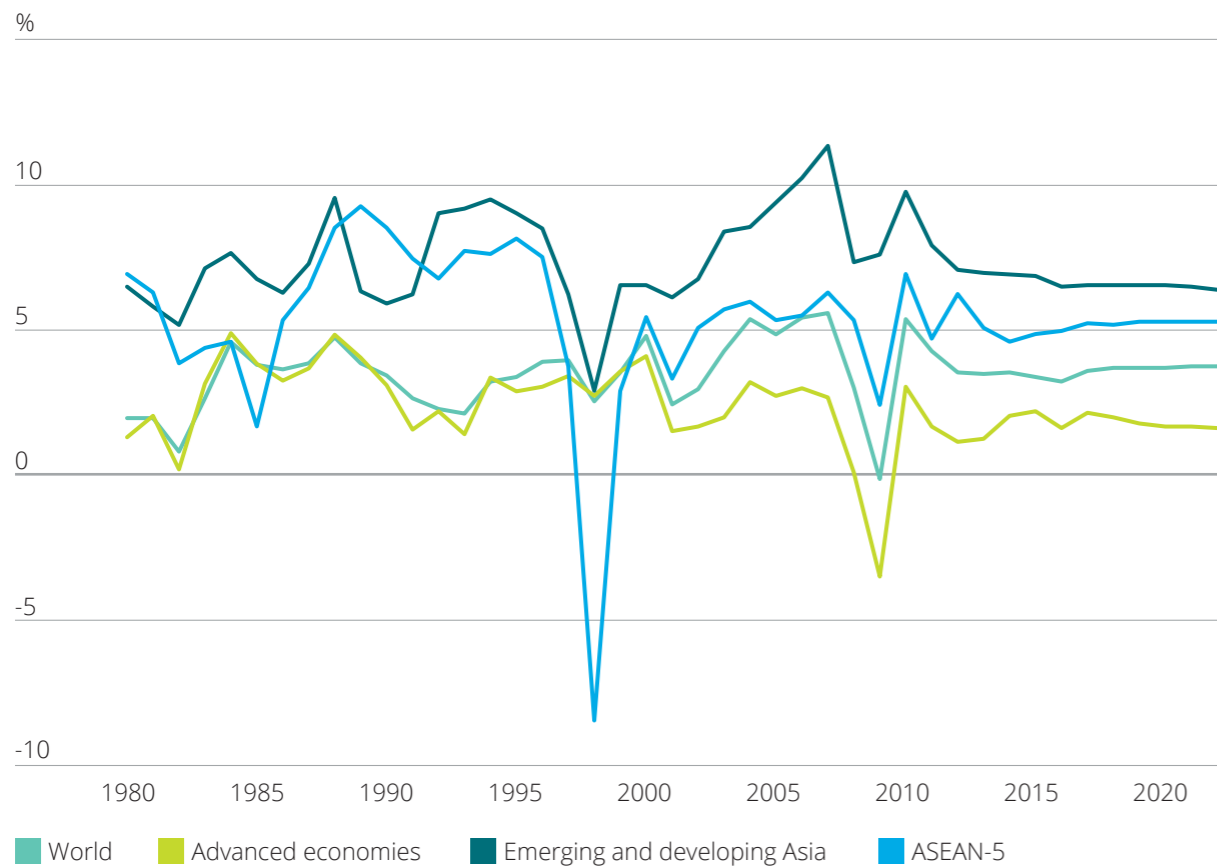
The global economy has turned a corner, with demand rising robustly since late 2016, and we believe that it will likely accelerate (figure 1.1). This cyclical upswing in the world economy has supported the broad-based lift in activity in Asia Pacific. More than 75 percent of the world economy is now enjoying an upswing, with forecasts anticipating global growth to rise to 3.6 percent in 2017 and 3.7 percent in 2018 from 3.2 percent in 2016.²⁰ Growth in advanced economies is at its fastest in three years, with OECD lead indicators pointing to slightly above trend growth (figure 1.2).

We believe there are three major forces at play that will power a modest acceleration in global demand, to the benefit of exporting nations in the Asia Pacific region.

The global economy is entering a cyclical upswing after close to a decade of crises and challenges

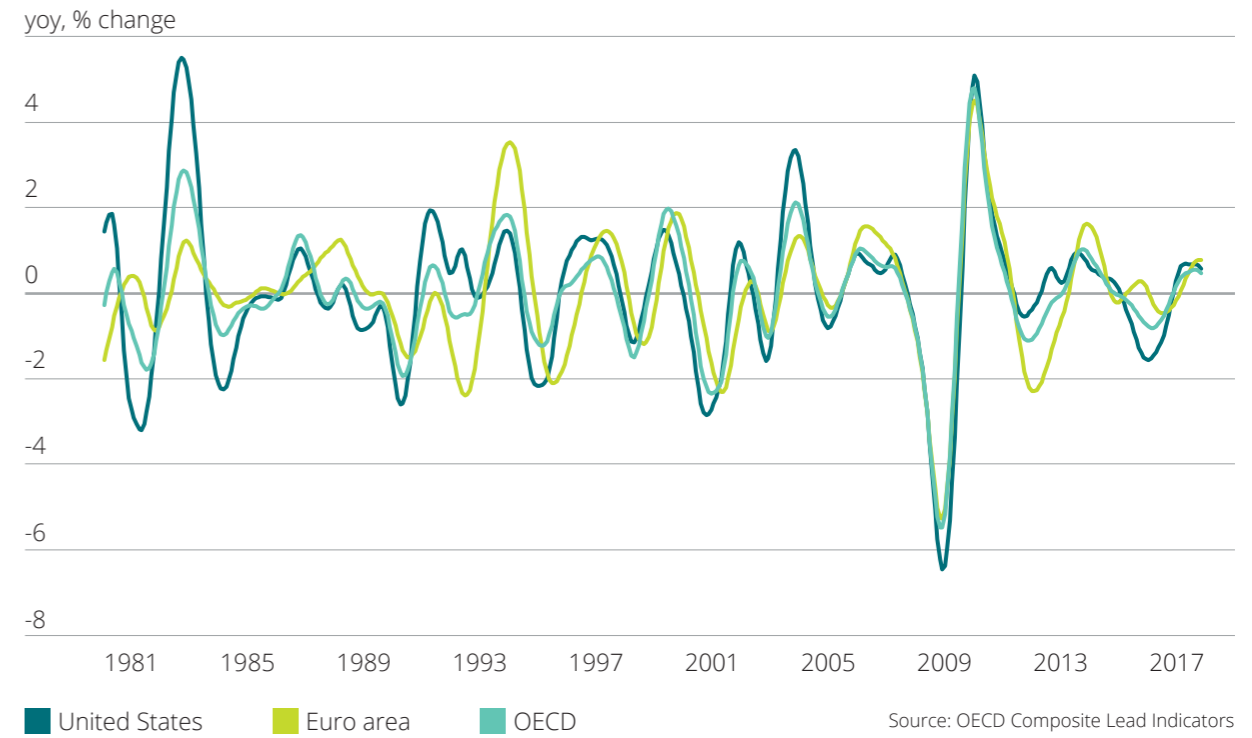
Simultaneous growth in most parts of the world produces an interesting dynamic where growth in some countries spills over into other groups of countries, reinforcing their recoveries which then spill back into the first set of countries, thus producing an upward spiral. The initial gradual rebound in activity in the United States boosted demand in other advanced economies such as the Eurozone and Japan. As the mutually reinforcing virtuous circles of economic expansion garnered greater momentum, trade-oriented East Asian economies joined in the economic upswing and gave an additional boost to the recovery in global demand, trade, and investment flows.

Figure 1.1: GDP growth by region*



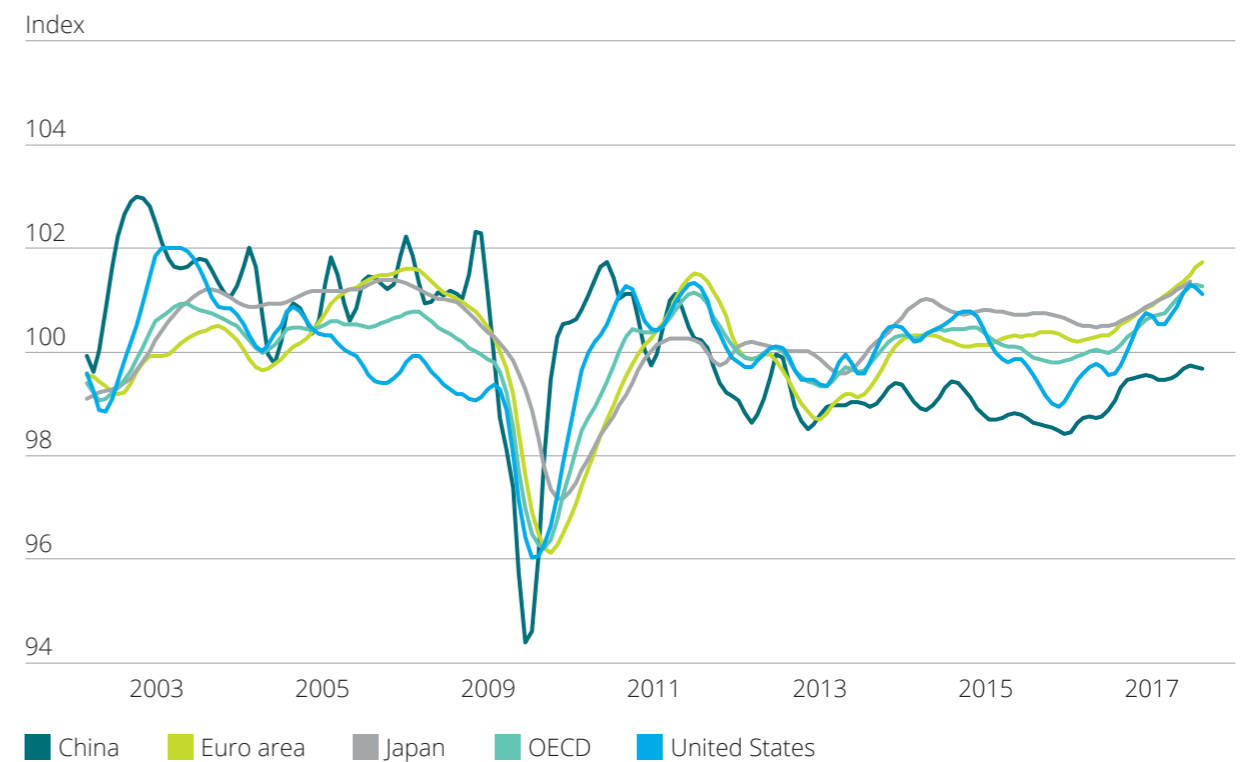
Source: International Monetary Fund, World Economic Outlook Database, October 2017
*Projections from 2017
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Figure 1.2: OECD CLIs



Source: OECD Composite Lead Indicators
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Figure 1.3: Major economies' Business Confidence Index*



Source: OECD Business Confidence Index
*Amplitude adjusted, long-term average = 100, Jan 2008–Nov 2017.
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Underpinning this dynamic is the return to normal health of key motors of activity in the economies that were hit by the global financial crisis. In particular, business confidence is on an upward trend, which will support greater levels of investment activity as businesses become more comfortable taking on risk again (figure 1.3).

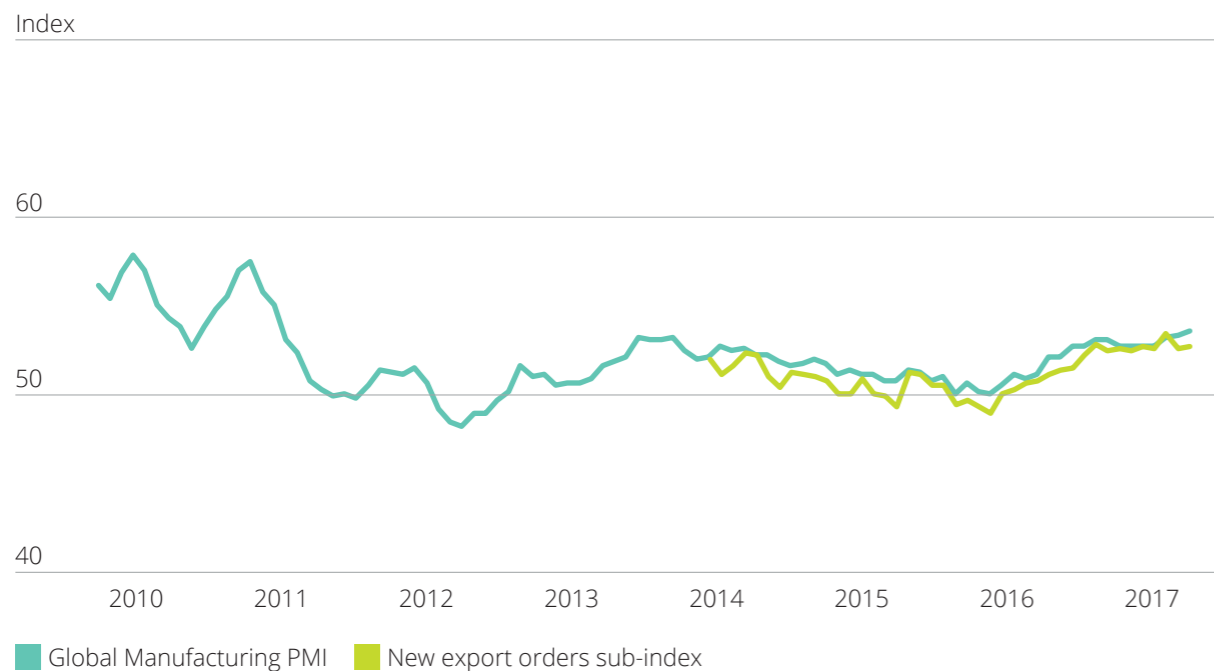
More of this recovery in demand and output is manifesting itself in the form of export demand; the underperformance of global exports relative to world output is reversing.

This is a huge benefit for Asian exporters of manufactured goods. The components of the WTO lead indicators for world trade—air freight, container throughput, electronics trade, and export orders—are all rising, suggesting that this rebound in global exports has further to go. The volume of world trade flows continues firmly on an upward trajectory, with the CPB World Trade Monitor rising 5.1 percent year over year in September 2017, up from 4.5 percent in August 2017 and extending a run of accelerating increases since February 2016. The broader trend is that of sustained growth since late 2016—a marked shift from growth that was below 2 percent, or sometimes even negative, in the period 2015–16.

The uplift in trade has been supportive of the strongest improvement in business conditions in over half a decade, with the Global Manufacturing Purchasing Managers' Index (PMI) clocking in at 53.5 for October 2017, its highest level since May 2011 (figure 1.4). The sub-index for new export orders—a lead indicator for future Global Manufacturing PMI performance—is also around its recent high.

Regional economies are gathering momentum, with the more trade-oriented ones such as Malaysia, Vietnam, Singapore, South Korea, Taiwan, and Thailand standing to benefit most. Export demand has filtered into manufacturing activity and then generated demand in ancillary areas such as port and airport activity, logistics, and trade-supporting services such as trade finance. Even for countries and territories that are not very export-oriented, outward shipments have seen some stability over the previous year. This has largely been true for India, where exports revived in 2017 and further from April to October 2018, after two consecutive years of weak growth.²¹ Much of this increase in exports was generated in engineering goods, textiles, pharmaceuticals, and chemical products rather than traditional commodities.

Figure 1.4: Global Manufacturing PMI and new export orders



Source: Calculated by Centennial Asia Advisors using CEIC database
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Figure 1.5: EMDE capital flows



Source: IMF World Economic Outlook, October 2017
Deloitte Insights | Deloitte.com/Insights

Extremely accommodative global financial conditions continue to support the global recovery

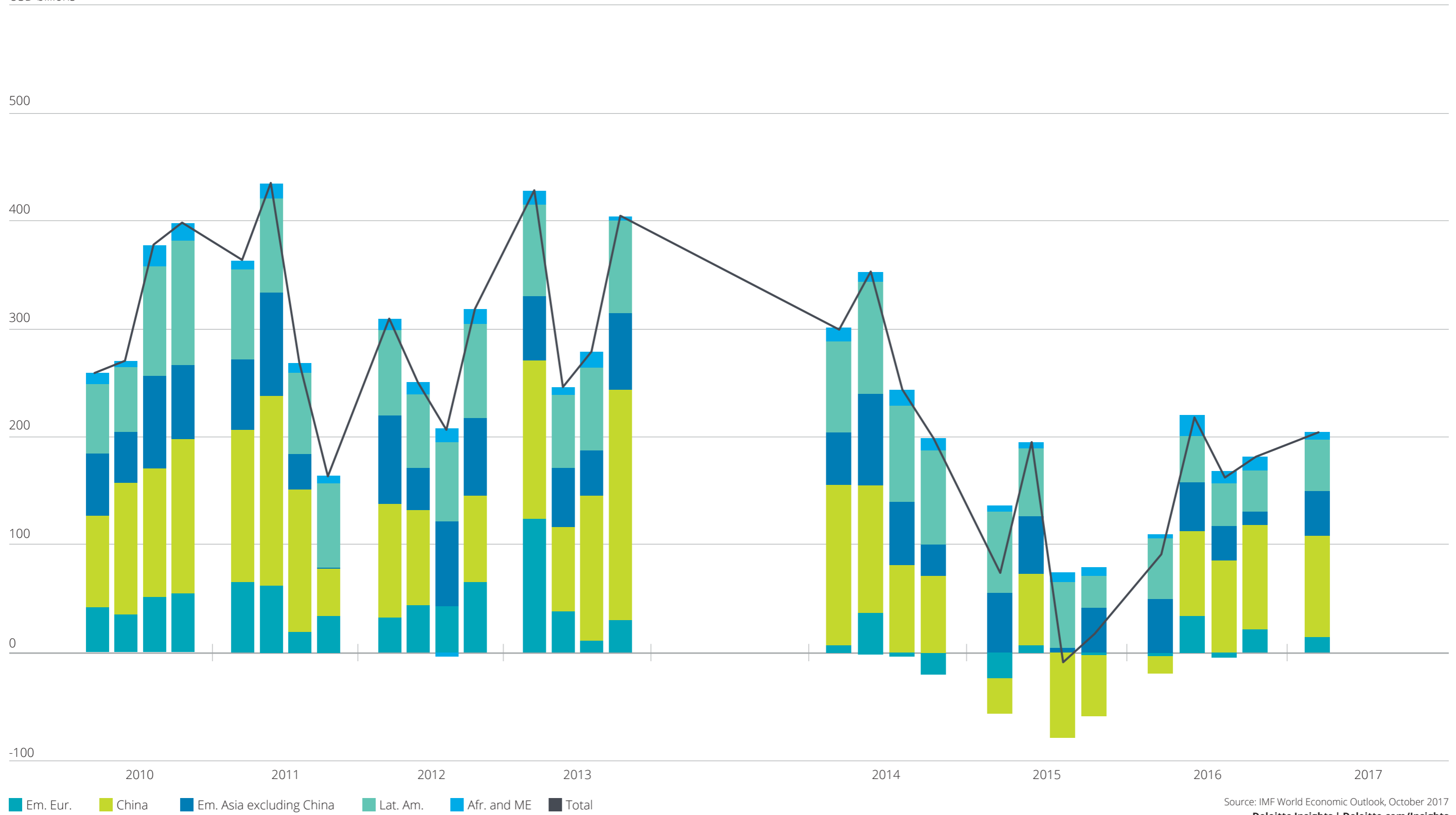
Generally, global financial conditions remain accommodative, in large part because signs of inflationary pressures remain remote. Equity markets have strengthened and volatility is low. Credit availability is generally not an issue as interest rates remain low (with the exception of China). Asset markets in many countries have benefited from this liquidity, helping to support household and business balance sheets. At the same time, capital flows into the emerging market and developing economies (EMDE) have returned (figure 1.5) and non-resident capital inflows to the region remain resilient (figure 1.6).

Despite stronger activity, price pressures remain subdued, giving space for central banks to maintain accommodative monetary policy to support the economic recovery.

Global financial conditions remain accommodative, in large part because signs of inflationary pressures remain remote.

Figure 1.6: Nonresident capital inflows to EMDEs

USD billions



Source: IMF World Economic Outlook, October 2017
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There are tantalising signs of a further strengthening in private capital expenditure

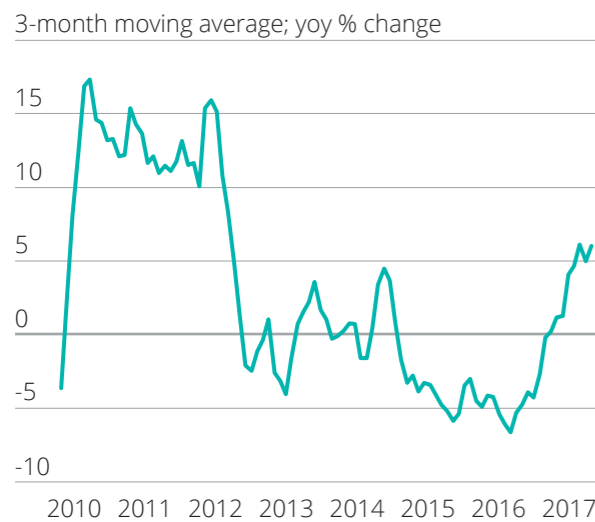
Investment spending has been the missing ingredient in the global recovery; yet there are signs that it could return. What’s more, Asian exports of manufactured goods are quite sensitive to capital spending—a recovery here would add substantially to global demand for Asian exports.

We have seen core capital goods orders rise in the United States (figure 1.7), and the Tankan survey²² shows capacity utilisation in Japan at its tightest since 1991 (figure 1.8).

Indeed, for the first time since the bursting of its stock market bubble in 1990, the Tankan survey indicated that demand exceeded capacity for large Japanese companies.

In the Eurozone, easing credit conditions will provide more support for companies’ investment plans in the world’s largest import market.²³ Just as banks are becoming more willing to lend, rising business confidence suggests that firms will be more willing to borrow to expand. This is seen in the economic confidence index for the Eurozone, which recently rose to 114.2, its highest level since January 2001.²⁴

Figure 1.7: US—New orders of core capital goods



Source: Calculated by Centennial Asia Advisors using CEIC database, FRED

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In particular, indicators of demand for technology goods such as semiconductor billings and the Fed’s Tech Pulse index are also at multiyear highs (figure 1.9). This is a new structural driver of growth: new and proliferating technologies such as data analytics, artificial intelligence, and the Internet of Things are taking off, producing sharp increases in the demand for a variety of electronics components manufactured in East Asia. A rise in global demand for technology could also positively impact foreign flows to India, especially with government initiatives such as “Make in India” and “Digital India” gaining increasing visibility.

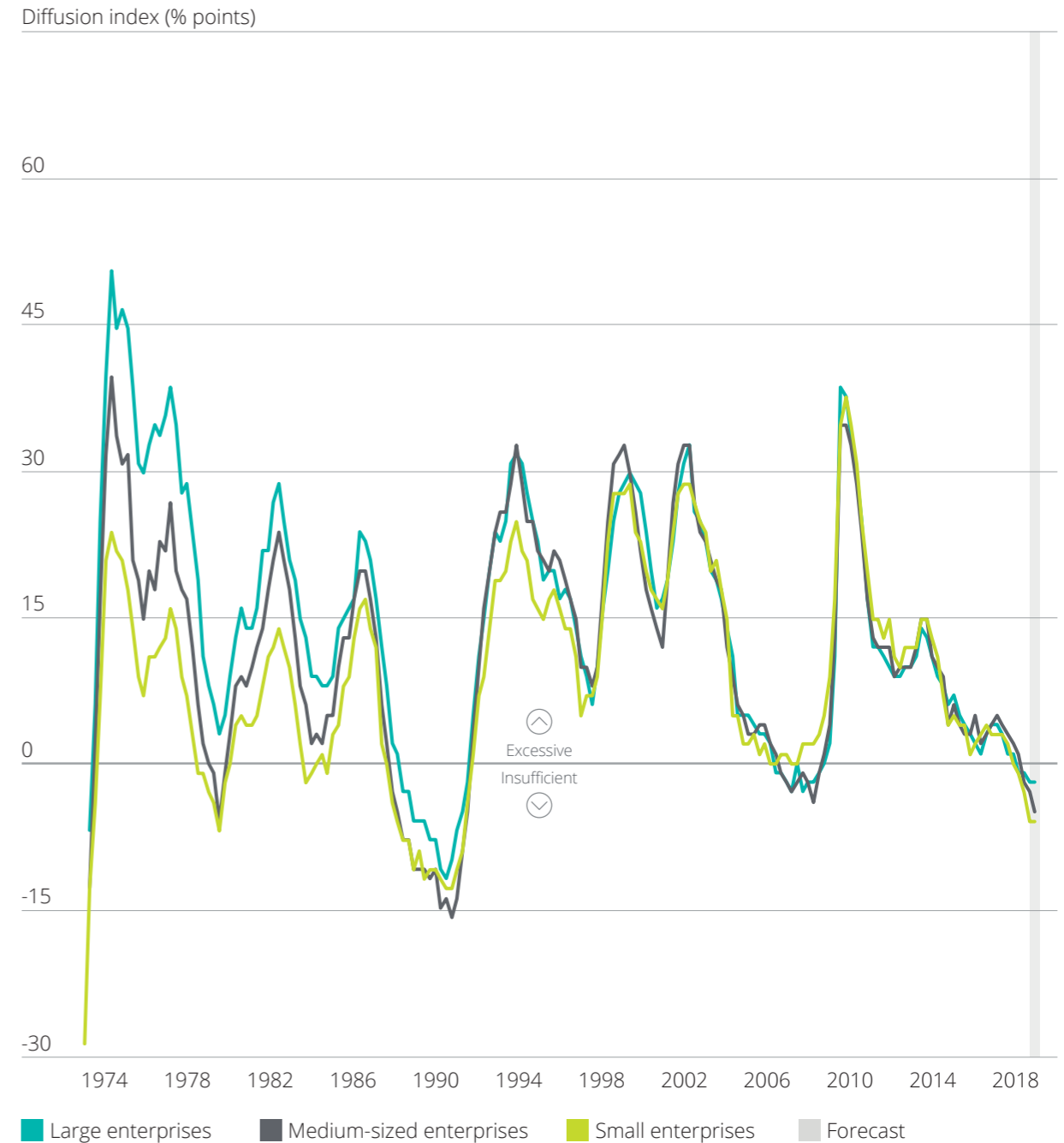
Additionally, there are also underlying forces at work in the global economy that strengthen the case for a material uptick in investment.

- The tax bill approved in the United States in December should support an increase in investment given the emphasis on a large tax cut for American corporations.
- With the successful conclusion of the 19th Party Congress in China, the firmly ensconced President Xi Jinping will continue to progress his hallmark Belt and Road Initiative. This will drive a massive injection of infrastructure-induced demand into Southeast Asian and Central Asian economies. China’s infrastructure initiatives will support the launch of mega infrastructure projects in the region.

The global economy is set for a new investment cycle that will bolster the rebound. Investment spending has high multiplier effects in the short term and, by boosting production capacity, generates long-term growth as well. Finally, the trade effects of growth driven by capital spending are more significant than growth driven mostly by consumer demand.

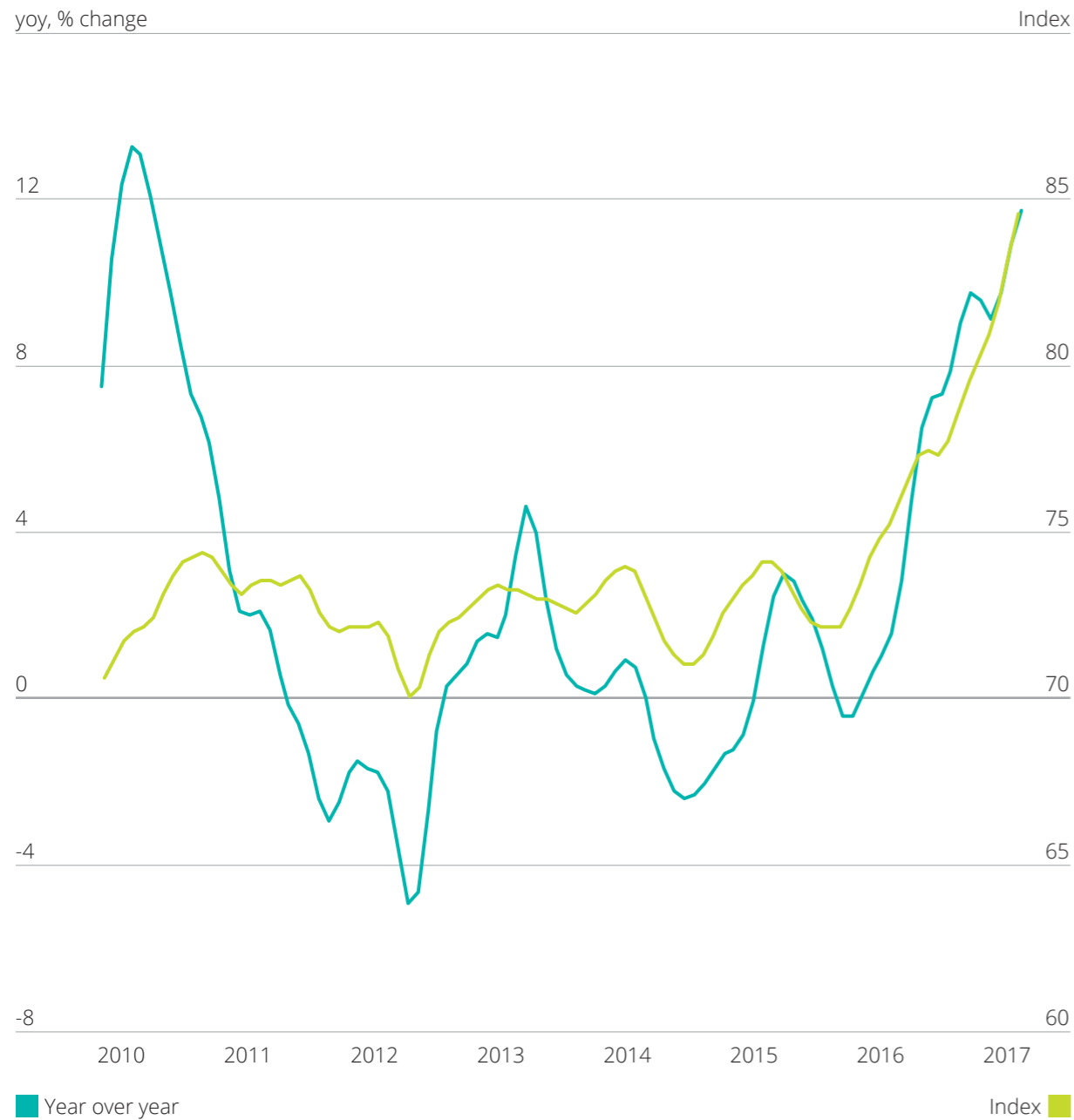
There is a lot to be positive about when considering the outlook for 2018. Yet if the unpredictability of the last few years has taught us anything, it is the importance of looking at the flip side—examining and being aware of what might happen, as well as what we think is likely to happen. This is what we look at in our second article “The flip side: Being aware of what could go wrong in 2018.”

Figure 1.8: Manufacturing production capacity in Japan



Source: Bank of Japan, Tankan Survey–December 2017
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Figure 1.9: US Fed Tech Pulse



Source: Calculated by Centennial Asia Advisors using CEIC database, FRED
Deloitte Insights | Deloitte.com/Insights

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The flip side: Being aware of what could go wrong in 2018

Our outlook for the Asia Pacific region over the next year is positive. Asian countries and territories enjoyed a stronger-than-expected year of economic growth in 2017, and this is set to continue into 2018.

The first article in this edition of *Voice of Asia*, “Strength from within and demand from outside: Asia’s continuing growth opportunity,” outlines the supporting roles played by steady recovery in global demand and accommodative financial conditions in this positive story. But it is the heavy lifting by the Asia Pacific economies themselves that has positioned them to make the most of the upswing.

Many economies in the Asia Pacific region have embarked on journeys of domestic structural reform. In some of these economies the pain of adjustment has now faded, and they are well placed to reap the benefits.

So there are reasons to be positive about the outlook for 2018. However, it is important to also acknowledge the downside risks on the horizon. We believe these are the areas to look out for in 2018:

- A major vulnerability in growing private sector indebtedness
 - Particular risk from highly leveraged household balance sheets in Australia and South Korea
 - Some potential fallout from Chinese corporate debt and shadow banking (a Minsky moment)²⁵
- The outside possibility of a major shock if geopolitical tensions intensify

In examining these, we are not predicting these risks as likely outcomes. In fact, we believe that the economies in Asia Pacific are better placed to deal with an external shock than in the past. But not all risks are external, and it will be important for authorities to manage these challenges carefully.

We believe the economies in Asia Pacific are better placed to deal with an external shock than in the past.

Growing private sector indebtedness

At the top of our list of the challenges facing the region is the build-up of debt from the post-2008 financial crisis period of excess global liquidity. The increase in government debt is attributed in part to the post-crisis economic downturn and the policy efforts by governments to support demand and stabilise financial markets (figure 2.1). In the ensuing decade, fiscal sustainability issues have received significant attention.

While achieving a sound fiscal position continues to be a priority for most governments, including Japan and Australia, we see the growing indebtedness of the non-financial private sector (the non-government sector excluding the financial sector) as a near-term source of vulnerability. Highly leveraged corporate and household balance sheets have left this sector vulnerable to shocks. How vulnerable the broader economies might be will depend on where the debt has accumulated as well as the strength of their financial systems.²⁶ In some instances, this debt has been channelled into housing markets, for example, in Australia, China, and Korea, raising concerns of asset price bubbles. We take a closer look at some of these below.

In the near term, the catalyst which tests these vulnerabilities may be related to intensifying geopolitical tensions, including greater levels of protectionism. While there is no cause to believe that tensions will suddenly escalate, the nature of these risks is that they can be unpredictable.

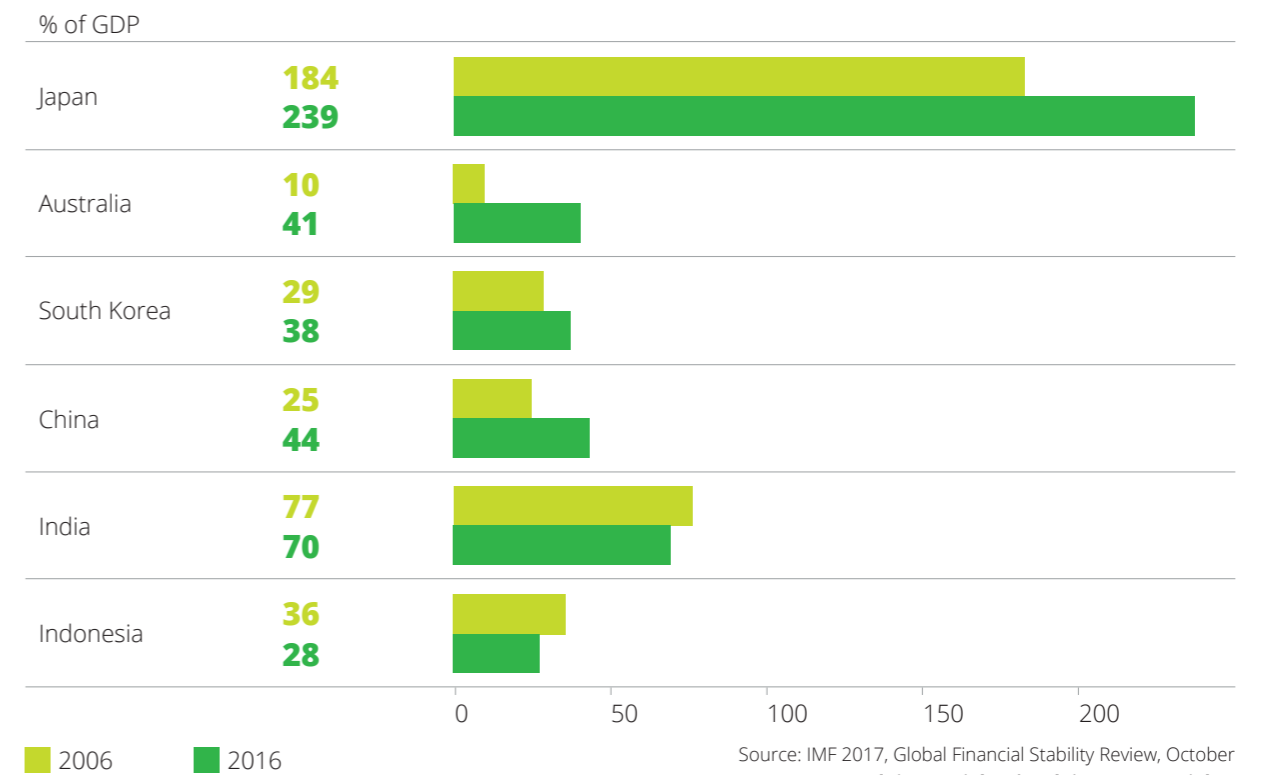
Amid easy financing conditions following the 2008 financial crisis, a number of the large Asia Pacific economies have seen a large increase in debt use by both households (figure 2.2) and non-financial corporations (figure 2.3).

The increase in household debt has been particularly prominent in Australia, China, and South Korea. Debt accumulation on its own is not necessarily a problem. The level of indebtedness matters, but it is not all that matters. It is important to understand what the debt is used for. For example, whether or not the funds are used productively and help generate future income streams. Generally, the increase in leverage has helped support aggregate demand following the downturn after the 2008 financial crisis.

Nonetheless, higher debt levels increase borrowers' sensitivity to interest rates. While interest rates are low at present, as they gradually normalise, borrowers will face greater debt servicing pressure. Debt servicing problems can lead to greater credit risk in the financial system, which in turn could have implications for the real economy. The debt service ratio (DSR) for the private non-financial sector in China nearly doubled immediately prior to the 2008 financial crisis (figure 2.4). The DSR in Australia and Korea has increased since the early 2000s, but remained broadly unchanged over the past decade despite debt use increasing significantly over this period.

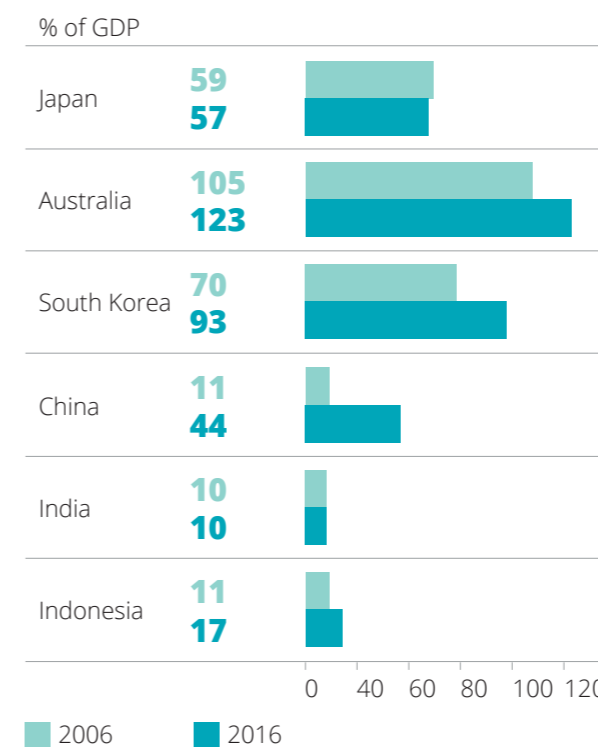
Build-up of debt from the post-2008 financial crisis period tops our list of the challenges facing the region.

Figure 2.1: General government gross debt



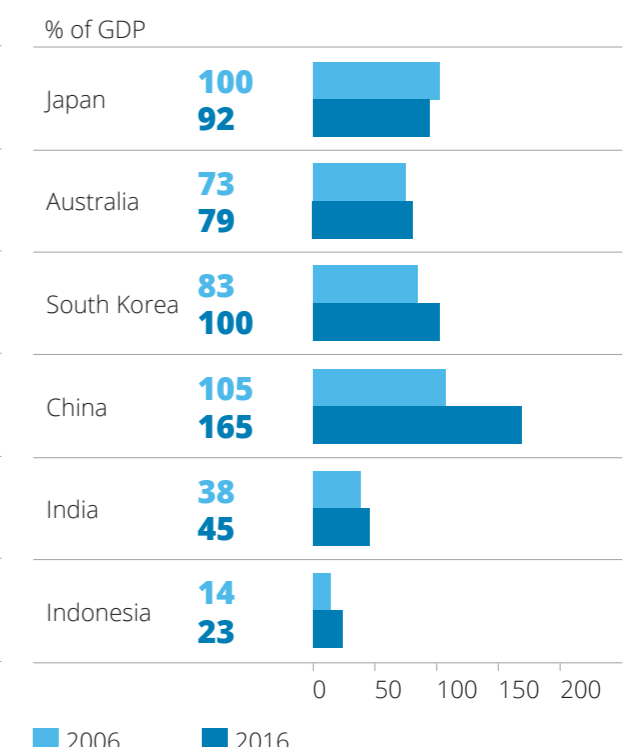
Source: IMF 2017, Global Financial Stability Review, October
Deloitte Insights | Deloitte.com/Insights

Figure 2.2: Households gross debt



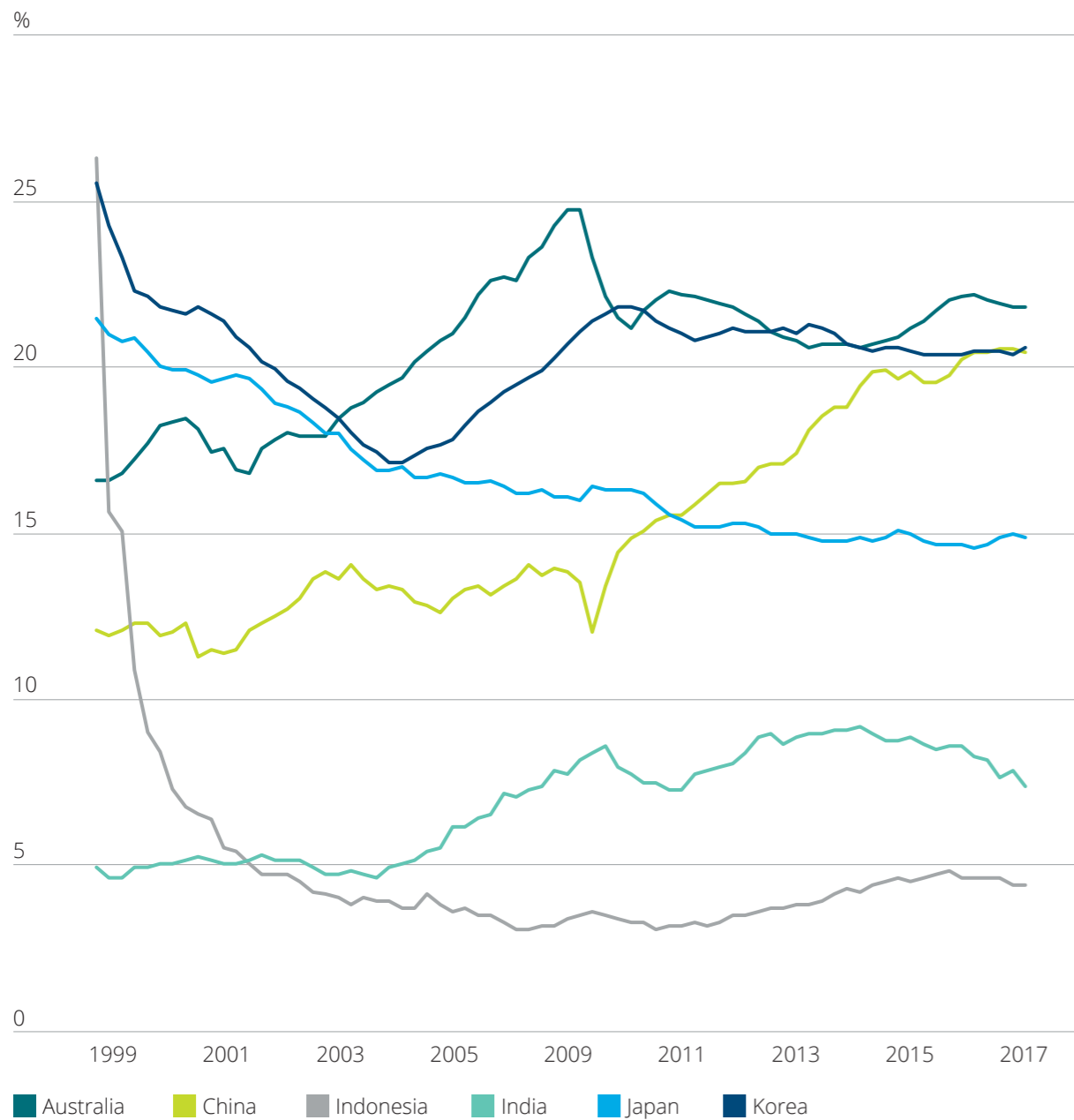
Source: IMF 2017, Global Financial Stability Review, October
Deloitte Insights | Deloitte.com/Insights

Figure 2.3: Non-financial corporations gross debt



Source: IMF 2017, Global Financial Stability Review, October
Deloitte Insights | Deloitte.com/Insights

Figure 2.4: Debt service ratios for private non-financial sector*



Source: BIS
 *Debt servicing cost is calculated as the fixed debt service cost of an instalment loan, based on an average interest rate on the existing stock of debt, divided by income.
 *As of June 2017.
 Deloitte Insights | Deloitte.com/Insights

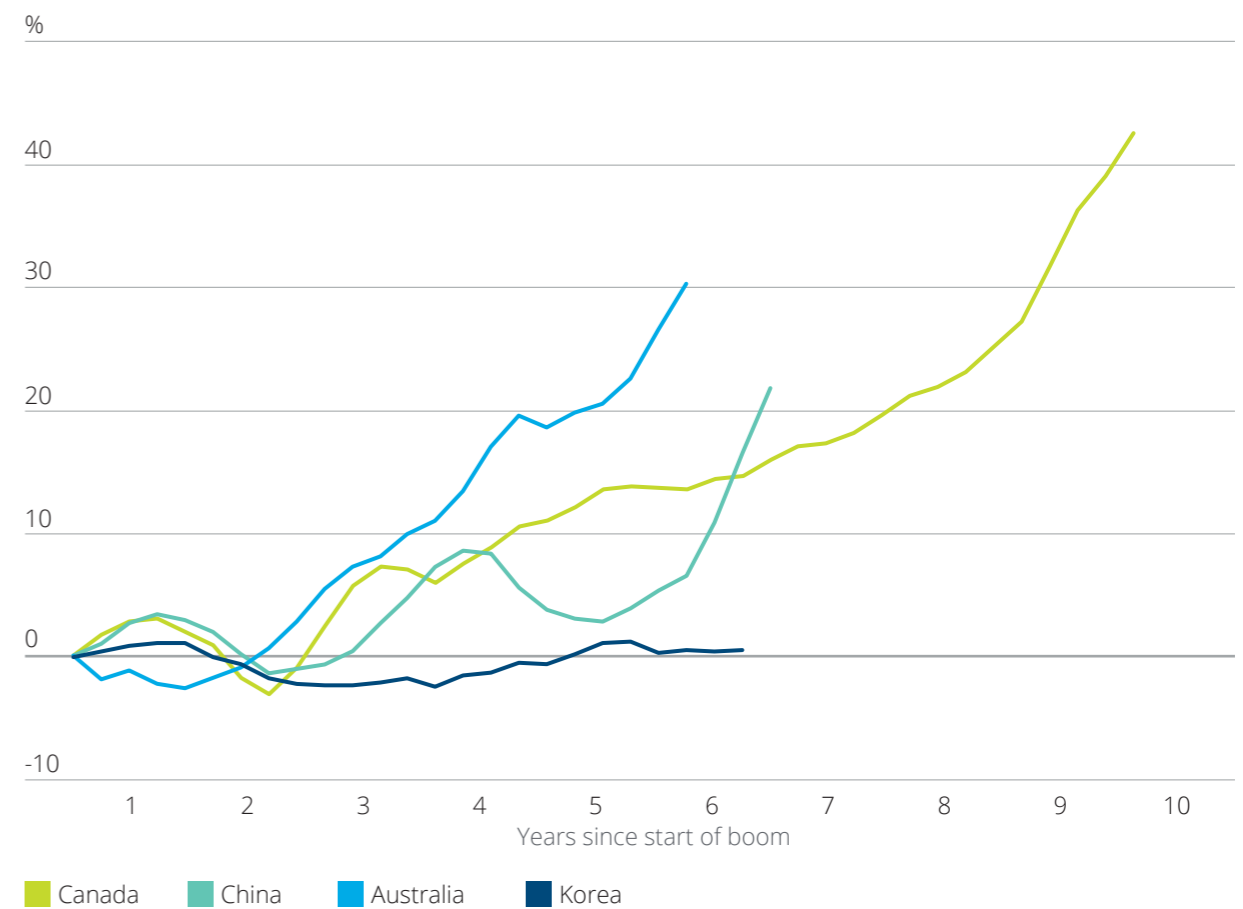
Highly leveraged household balance sheets in Australia and South Korea

The recent increase in household debt is generally associated with historically low borrowing costs, contributing to demand for housing. The latter has coincided with the return of households' risk appetite. Greater demand for housing contributes to higher house prices, leading to more collateral being available to property owners for additional borrowing. The concern is that these purchases are driving "irrational exuberance," and are creating asset price bubbles, thereby putting highly exposed household balance sheets at risk of a sudden price drop. If household balance sheets are funded by banks, a sharp price correction can lead to serious consequences for the banking system and for the real economy.

Along these lines, housing markets in Australia and China have experienced significant price growth (figure 2.5). However, the risk of a sharp price correction in these markets depends on whether the fundamentals of supply and demand are supportive of the market.

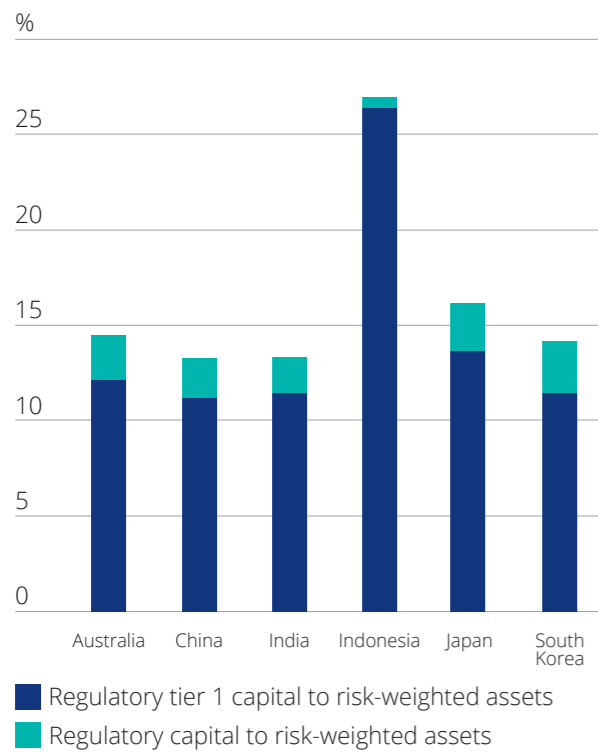
In Australia, house prices have risen for the past four years, mainly driven by strong demand and supported by population growth as well as domestic and overseas investment. At the same time, in key markets such as Sydney, supply has not kept up. In addition, lending standards have been strong and the prudential regulator continues to keep an eye on risks and has sought to manage them using its macro-prudential toolkit. The sector is well capitalised and loan quality is sound (figures 2.6 and 2.7).

Figure 2.5: Debt cumulative real house price growth



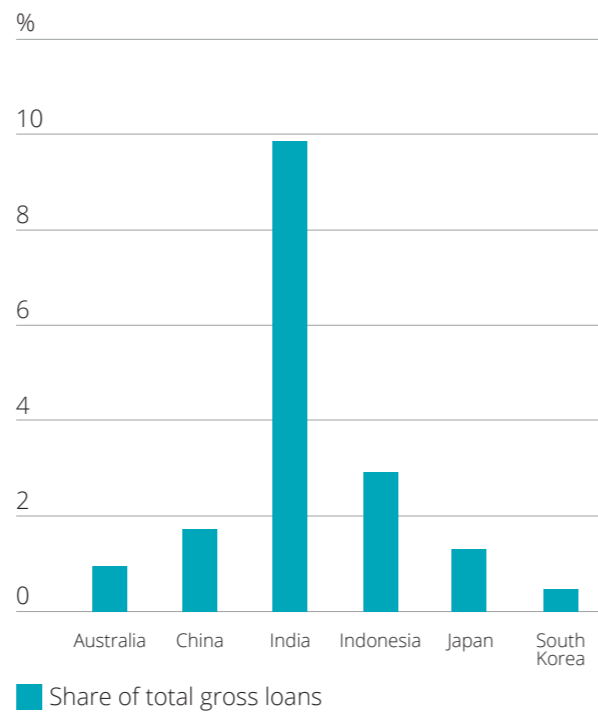
Source: IMF Global Financial Stability Review, October 2017
 Deloitte Insights | Deloitte.com/Insights

Figure 2.6: Deposit-taking institutions' capital adequacy ratios



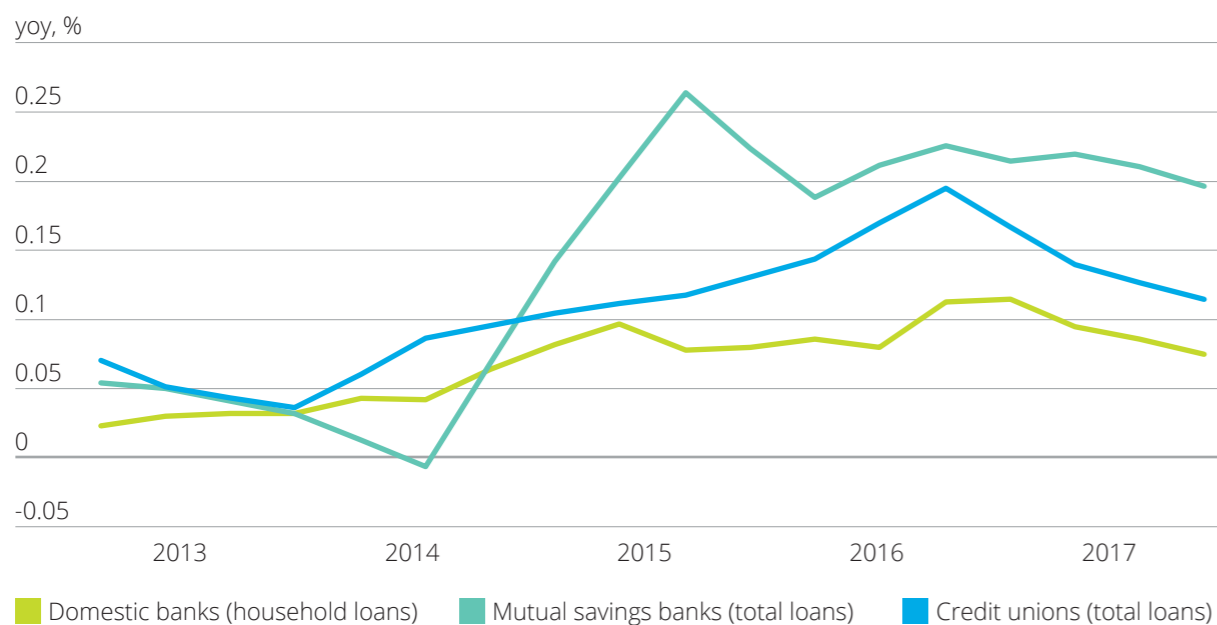
Source: IMF Financial Soundness Indicators
 Note: Data is as of Q1 2017 for Australia; Q2 2016 for China; Q2 2017 for India; 2017 for Indonesia; Q1 2017 for Japan; and 2014 for South Korea.
 Deloitte Insights | Deloitte.com/Insights

Figure 2.7: Deposit-taking institutions' non-performing loans



Source: IMF Financial Soundness Indicators
 Note: Data is as of Q1 2017 for Australia; Q2 2016 for China; Q2 2017 for India; 2017 for Indonesia; Q1 2017 for Japan; and 2014 for South Korea.
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Figure 2.8: Loan growth—banks, mutuals and credit unions



Source: Deloitte calculations, Financial Supervisory Service
 Deloitte Insights | Deloitte.com/Insights

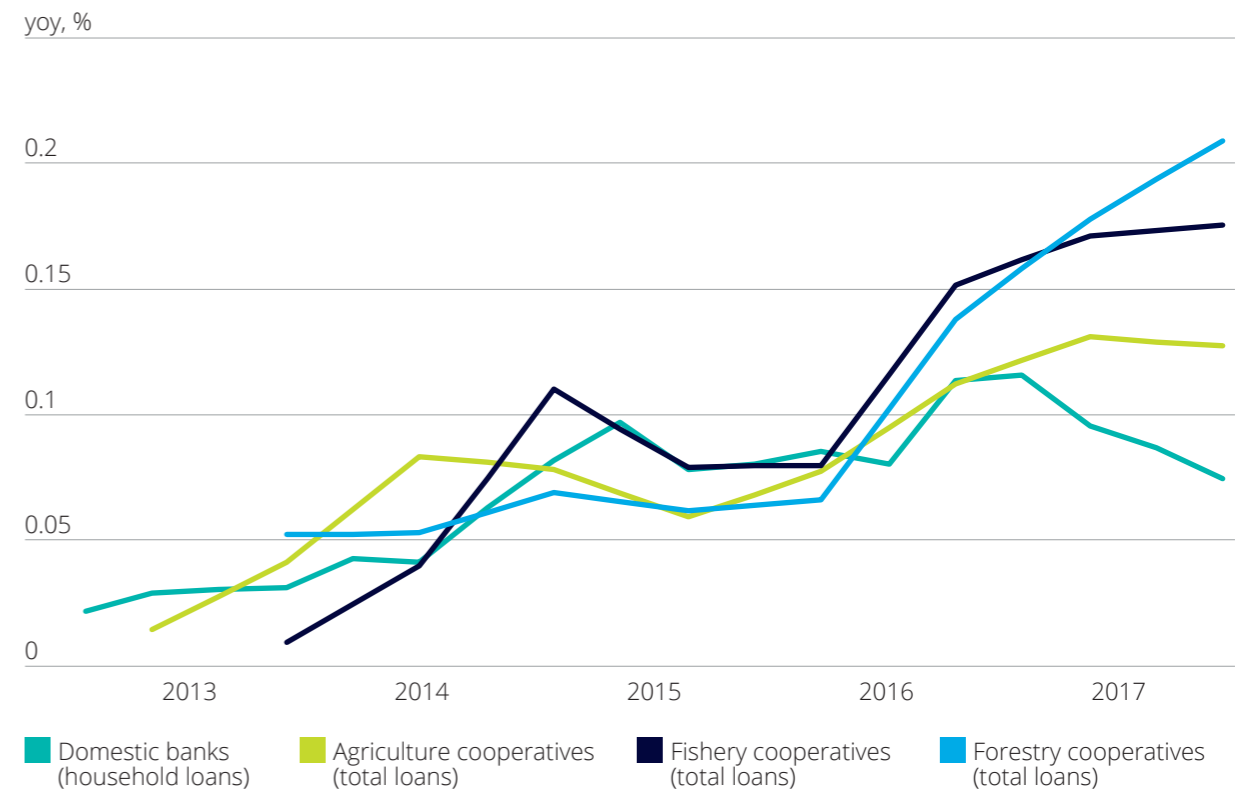
While Australian banks are highly exposed to residential mortgages, the major banks' stress tests demonstrate that they are resilient to significant shocks. On balance, while prices in Sydney, and to a lesser degree Melbourne, have eased a little in recent months, we don't believe that a sharp price correction is likely in the near term, although highly leveraged household balance sheets remain a source of concern.

Housing price rises in South Korea tend to be limited to certain areas in big cities. For example, the average apartment price in Seoul has risen more than 20 percent over the past four years.²⁷ South Korea's household DSR ranks as one of the highest among G20 advanced countries.²⁸ On the other hand, household balance sheets appear relatively sound.

At the same time, the South Korean government has now become serious about stabilising the city's property markets by introducing tighter mortgage requirements and raising capital gains taxes. Authorities will also need to manage the implications of the large flows of household credit extended via less stringently regulated non-bank financial institutions—which has outpaced household loans made by the banking sector since 2011.²⁹

In the past four years, total loans by non-bank financial institutions have grown at one and a half to two times the rate of household loans extended by the banks (figures 2.8 and 2.9).³⁰

Figure 2.9: Loan growth—banks, and cooperatives



Source: Deloitte calculations, Financial Supervisory Service
 Deloitte Insights | Deloitte.com/Insights

While Chinese authorities should remain cautious, there are no signs of a major correction in 2018.

Chinese corporate debt and shadow banking

The rise in corporate debt has been driven by easy credit. Lower interest rates and low market volatility have allowed companies to borrow more affordably. Expansionary monetary policy following the 2008 financial crisis have sought to encourage greater investment by businesses. The rapid increase in debt levels of non-financial corporations in China has largely been driven by the state-owned enterprises (SOEs) (figure 2.10).

The characteristics of the rapid accumulation of debt are a cause for concern. The increased use of short-term wholesale funding, the significant role played by shadow banks, as well as small and medium-sized banks, in extending credit, have, according to the IMF, “increased the opacity of intermediation, increased the use of unstable short-term funding, and raised sensitivity to liquidity stress (figure 2.11).”³¹

Zhou Xiaochuan, governor of the People’s Bank of China, recently warned of a possible Minsky moment facing China. He stated that “if we are too optimistic when things go smoothly, tensions build up, which could lead to a sharp correction, what we call a ‘Minsky moment’. That’s what we should particularly defend against.”³²

However, the situation in China today does appear to be quite different to that of Japan in the early 1990s—the time of the last classic Minsky moment in a major economy in the region—when the real estate and stock market bubbles burst. While there are concerns about house price inflation in major cities (figure 2.5) and debt levels, with the debt servicing burden rising rapidly (figure 2.4), Chinese authorities are very aware of the financial system risks and have been working to implement measures to reduce the current imbalances. At the same time, the government has large fiscal buffers, economic growth is solid, and the banking sector asset quality appears relatively sound (figures 2.6 and 2.7).

While Chinese authorities should remain cautious, there are no signs of a major correction in 2018. The successful mitigation of financial stability risks by Chinese authorities will mean managing the impact of tightening credit conditions becoming an excessive drag on economic activity. Deleveraging of the SOEs is an opportunity to clean up some of the underperforming enterprises that are weighing on competitiveness in the long term. At the same time, meaningful reforms to continue financial sector liberalisation and broaden the sources of growth in the economy will be important to longer-term sustainability.

Figure 2.10: Gross debt in China

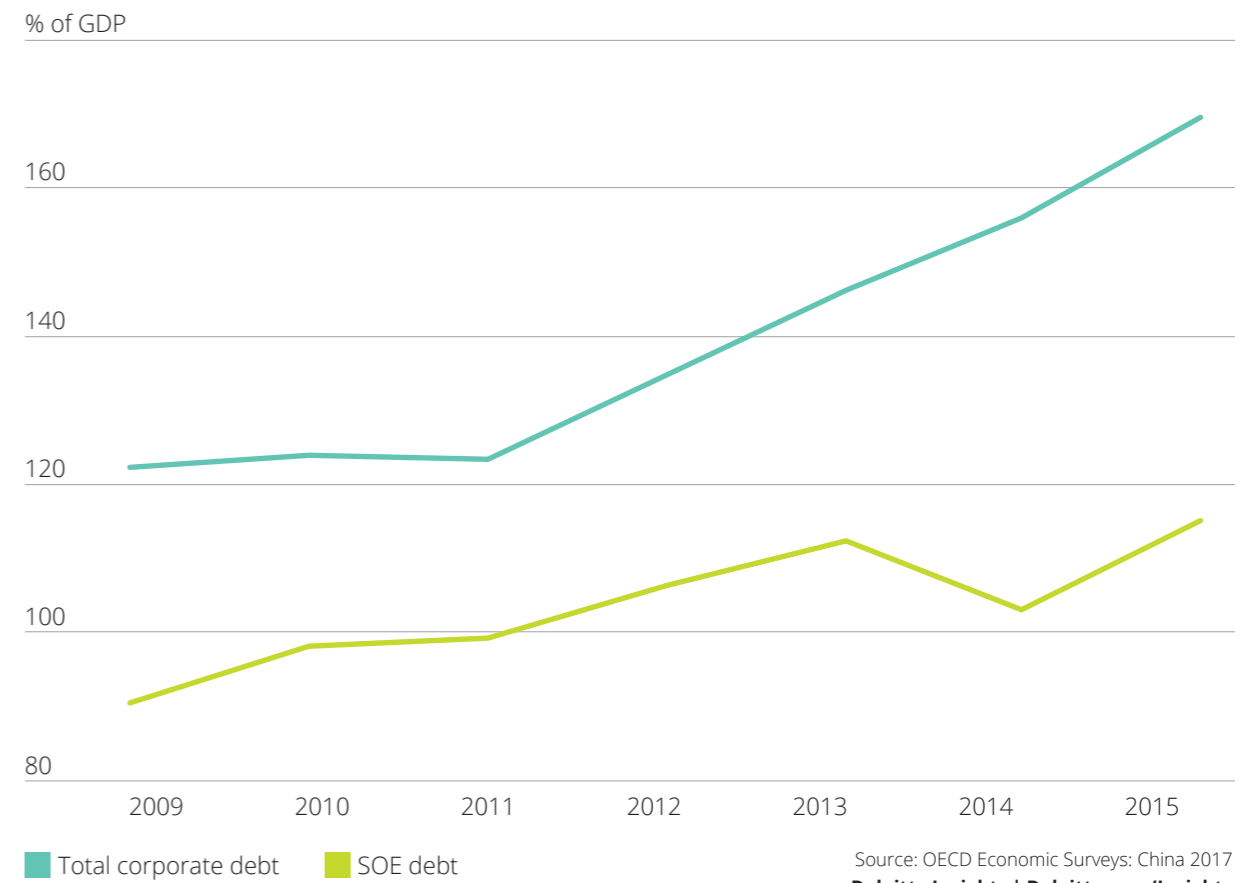
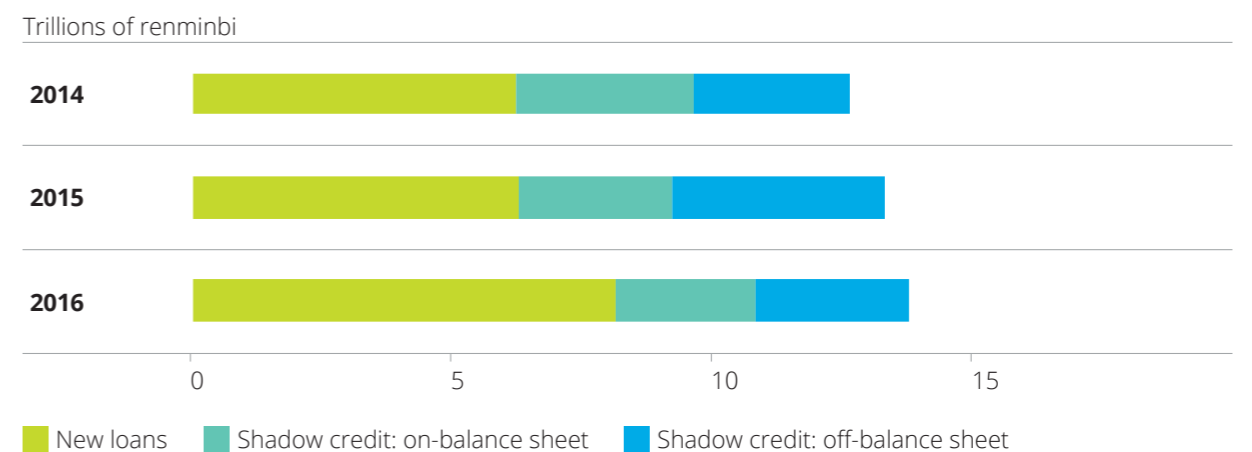


Figure 2.11: Net increase in private non-financial credit



Geopolitical tensions intensifying

The spread of global protectionist sentiment is a concern for the Asia Pacific economies. The United States has announced its intention to review all legacy free trade mechanisms through the lens of its “America First” trade policy. The US Trade Representative’s ongoing investigation of China’s intellectual property rights and technology transfer rules is another shot across the bow of the Sino-US trade relationship. While actual US movement to address its bilateral trade imbalances was rather limited in 2017, this is likely to intensify in 2018 before the mid-term elections in November. On the other hand, it is difficult to see trading partners coming to the table, given the US administration’s unrealistic trade negotiation mandate. The intention is to eliminate the country’s bilateral trade deficits (which are simply a product of broader macroeconomic conditions and influences).

Nonetheless, the impact of the United States erecting trade barriers would be strongly felt, not only by countries and territories with huge bilateral trade surpluses with the United States (including China, Japan, and Korea), but also by Malaysia, Thailand, and Vietnam, where high manufacturing export levels to the United States are a large share of GDP. Reversing the decades of progress on trade liberalisation will be detrimental to both the United States and its trading partners, particularly if it leads to retaliatory measures.

While the October 2017 currency report of the US Treasury did not label China a currency manipulator, it kept China on a currency “monitoring list.” The risk of tensions in the Sino-US relationship escalating from rhetoric into counterproductive policy measures remains a concern. The implications of a currency war would be devastating for the ongoing global recovery. But further US aggravation of this issue may be unlikely in the near term. The US administration is looking to Beijing to align with their tough stance on North Korea, which could moderate their willingness to further put the Chinese government off side.

More broadly, rising military tensions over North Korea could be the trigger of world risk-averse sentiment and form the basis of the reversal of capital flows. Military engagement would entail huge human and physical damage to countries directly involved, potentially including not only South Korea, but also Japan and China. Now that the international and Chinese economic sanctions against North Korea have been further strengthened, chances of a breakthrough in the standoff may be receding.

An escalation of tensions could rock business and consumer confidence and be a source of economic instability. Indeed, given the high levels of debt in key parts of the Asian economies as outlined above, such an escalation could prove to be the catalyst for a sharp correction in investors’ willingness to support further growth and hit financial markets in the region. However, the various forces currently appear to be in balance, albeit a delicate one.

25 A Minsky moment is generally defined as an abrupt huge collapse of asset prices as a result of the credit or business cycle.

26 Many countries continue to take steps to strengthen their financial systems following the 2008 financial crisis. For example, the Indian government recently announced its INR 2.11 trillion banking recapitalisation plan.

27 *Financial Times*, “South Korea looks to cool property market with tax rise,” August 2, 2017.

28 According to the IMF, October 2017, GFSR, gross debt to income ratio of households in 2016 reaches more than 150 percent, and its debt service ratio diverges higher from the mean by around 1.5 percent.

29 IMF, “Republic of Korea: 2016 Article IV Consultation—press release,” August 26, 2016.

30 Data is not available for household loans by non-banking financial institutions (NBFIs). The NBFIs used in the comparison—mutual savings banks and mutual credit cooperatives—mainly provide retail and small business banking.

31 IMF, “Global financial stability report,” October 2017.

32 *Financial Times*, “China central bank governor warns of Minsky moment,” accessed January 2018.

Economic outlook

As we look at what's ahead for 2018, it's important to take a closer country- and-territory-specific look to uncover shared trends and collective insights across the Asia Pacific landscape.

In this edition of *Voice of Asia*, we asked each country or territory to provide their outlook for 2018 and rank the following themes by importance for the year ahead:



US leadership



US growth and monetary policy



Trade



The Korean Peninsula



China post the 19th National Congress of the Communist Party



The Belt and Road Initiative

China

A stronger US economy and synchronised global recovery worked well for China in 2017, but the economy is likely to slow in 2018 for two reasons. First, having prioritised containing financial risks in the wake of the 19th Party Congress, the government is likely to restrain credit growth, which could hurt growth in the short term. Second, the excellent economic performance in 2017 (growth of 6.9 percent)³³ provides a high base, making it difficult to repeat that performance. However, such a slowdown will be welcome if policymakers succeed in reining in credit growth and meaningfully liberalising the financial sector so that foreign capital can help deleveraging. Given China's tight labour market and consumers' immense room for taking on debt, a lower GDP growth target is the best way to mitigate risks of a Minsky moment. The government is also expected to use the fiscal lever to alleviate poverty, as pledged in the 19th Party Congress.

The challenge is to stay the course on policy, especially with regard to deleveraging the corporate and local government sectors, and avoiding the temptation to extend stimulus at the first hint of a slowdown—say if housing cools abruptly. Another risk is that America's tax overhaul diverts away foreign investment. Moreover, if the tax reform produces larger fiscal deficits, the US Federal Reserve would be prompted to be more hawkish, precipitating capital outflows from emerging markets, including China. Given these challenges and rising global interest rates, the best policy responses are to embrace a slower GDP growth target and to use the RMB as a shock absorber. The broad-based correction of the USD over 2017 has put the RMB at a two-year high, potentially giving authorities some leeway to permit the RMB to depreciate and delay interest rate rises amidst the US Federal Reserve's tightening cycle.

Ranking of themes by importance for 2018: China



Source: Deloitte and Centennial Asia Advisors Pte Ltd

Hong Kong

Hong Kong's economy has been supported by the synchronised recovery of the world's developed countries and the stabilisation of the Chinese economy. Economic performance in 2018 is likely to be a continuation of 2017 as the global recovery broadens. Moreover, Hong Kong's greater integration with China through the Greater Bay Area initiative will enhance economic prospects in the longer term.³⁴ Hong Kong will gain synergies from the strengths of cities such as Shenzhen, Guangzhou, Huizhou, and Zhongshan within the Bay Area, while demand for its services such as financial, public health, and transportation management will grow.

Housing affordability has become an increasingly acute issue for the SAR government in recent years, so higher interest rates will present less risk in 2018 than in the past. In fact, the SAR government could increase land supply if the housing market frenzy does not abate. In short, Hong Kong could well stay in a sweet spot in 2018.

The final challenge for Hong Kong remains the dilemma of how to integrate further into China's economy while still maintaining the "one country, two systems" formula that has served it so well.

Given the HKD's peg to the USD, local asset markets will be volatile, held hostage to perceptions of the trajectory of USD interest rates. However, even assuming four rate hikes in the United States in 2018, continued recovery implies that real interest rates could fall, as inflation will rise.

Ranking of themes by importance for 2018: Hong Kong



Source: Deloitte and Centennial Asia Advisors Pte Ltd

Japan

The Japanese economy is expected to stay buoyant during 2018, supported by strong external demand; record-breaking corporate profits, which will power higher capital expenditures; and improving household income, which will drive consumer spending.

The prospects for inflation remain uncertain though. With the labour market at full-employment levels, continued strong growth in 2018 should put upward pressure on prices. Also, the government is using tax incentives and moral persuasion to press corporations to accelerate wage rises. Much hinges on how Japanese corporations react to these pressures.

Structural reform and controlling the fiscal deficit are other important issues influencing the medium-term economic trajectory. Reforms such as loosening labour legislation, widening the range of households that qualify for free higher education, and facilitating access

to childcare, aim to increase labour productivity and labour supply. However, the ballooning fiscal deficit remains a challenge; some combination of raising income and consumption taxes and reducing social security expenditures is needed.

Lastly, now that the Liberal Democratic Party (LDP) has secured more than two thirds of the seats in both the upper and lower houses, the Abe government is likely to propose constitutional changes through a national referendum in 2018 or 2019. The administration runs risks similar to those faced recently in the United Kingdom and Italy—with the government proposal being rejected by the populace and the sudden collapse of the ruling cohort. Long seen as a symbol of stability in Japan, the sudden collapse of the ruling Abe LDP government could be very destabilising for the country.

Ranking of themes by importance for 2018: Japan



Source: Deloitte and Centennial Asia Advisors Pte Ltd

South Korea

In 2017, the Korean economy was in a recovery phase, driven by the global economic recovery and increased domestic demand. The Korean economy in 2018 is anticipated to continuously rise because of improving global economic conditions and the improvement of Korea-China relations, minimising the potential for economic damage caused by the THAAD missile issue. Additionally, the government's employment expansion policy, minimum wage hikes, prudent rate hikes, and Won appreciation are expected to help stabilise inflation and improve consumer sentiment. Consequently, a 2.5–3.0 percent GDP growth rate is expected in 2018.

In terms of industries, semiconductors will stay strong and contribute to the export market recovery. The automobile industry is expected to gradually recover after a tough period in 2017. The consumer

goods and retail industries will grow as consumer sentiment improves. Nevertheless, the slowdown in construction and facility investment will bring negative impact to the construction, steel, and associated industries.

To continue strengthening and maintaining the economic recovery, it will be necessary for the government to foster high value-added industries, strengthen technological competitiveness, and diversify export markets. Additionally, the prevention of excessive inflation and the establishment of a social safety net through quantitative expansion and qualitative improvement of jobs are crucial to stabilise the domestic market. As North Korea's nuclear tests are recognised as the largest risk factor to the recovering economy, policies should be implemented to resolve market anxiety and stabilise the market.

Ranking of themes by importance for 2018: South Korea



Source: Deloitte and Centennial Asia Advisors Pte Ltd

India

In many ways, 2017 was a defining year for the Indian economy. India completely reset its indirect tax system to a comprehensive GST while still experiencing the impact of the demonetisation shock of November 2016. The spike in GDP growth from 5.7 percent in the third quarter of 2017 to 6.3 percent in the fourth quarter suggests that the initially negative impact of GST and demonetisation may be waning.

Growth in 2018 is expected to be 6.8-6.9 percent,³⁵ putting India once again among the world's fastest-growing economies. With higher growth, we expect inflation to increase. Growth will be driven by private consumption, both urban and rural. The massive bank recapitalisation announced by the government is expected to increase private investment and create much-needed jobs.

Major external risks include oil price shocks, tax rate competitiveness, and growing barriers to trade. However, the Indian economy remains predominantly a domestically driven one, so the major downside risks will be domestic in nature, such as continuing disruptions from the implementation of the GST. The high levels of air pollution experienced in 2017 may precipitate policy measures taken to counter the "smog threat" which, in the short term, could cause more regulatory uncertainty and disruption in the economy.

In summary, after a year of disruption in 2017, 2018 is expected to be a year of consolidating the gains from recent reforms.

Ranking of themes by importance for 2018: India



Source: Deloitte and Centennial Asia Advisors Pte Ltd

Taiwan

GDP growth is generally forecast to be in the range of 2–2.5 percent in 2018,³⁶ maintaining this year's momentum and supported by vibrant demand for exports in all categories, especially technology, where the demand for next-generation electronics products is expected to be strong. However, given the lower-than-predicted demand for new Apple products (in particular the iPhone X) this year along with mounting competition from overseas, particularly China, in electronics manufacturing, Taiwan will need to consider how to move up the industrial value chain.

There was good news in this respect when machinery, accounting for 8 percent of exports, saw big gains in 2017 for the first time in a few years. Indeed, September 2017 saw a 56.5 percent year-over-year rise in the value of overseas shipments. Other major export industries (chemical products, plastics and rubbers, base metals) have also rallied after a few years of stagnation. The shortage of industrial land will continue to impact Taiwan in the next five years.

Consumer spending will also support growth in 2018, boosted by the government's plans to increase civil service salaries by 3 percent and lift the minimum wage by 4.7 percent. Low inflation and tax reforms will add further momentum to consumer spending.

China is Taiwan's top export destination, taking about 30 percent of all its exports. Therefore, China's new policy directions following the 19th Party Congress, as well as potential trade tensions with the United States, will impact export-dependent Taiwan. Deepening trade and investment links with other Asian countries will be a priority to decrease its economic dependence on China.³⁷

Finally, as a highly open economy, Taiwan is exposed to geopolitical instability, whether in the Middle East or in North Korea. As 30 percent of Taiwan's raw materials come from the Middle East and major supply chains are located in countries close to North Korea, these potential flashpoints are risks to Taiwan's prospects in 2018.

Ranking of themes by importance for 2018: Taiwan



Source: Deloitte and Centennial Asia Advisors Pte Ltd

Thailand

2017 was a remarkable year for Thailand as the economy clocked its highest GDP growth in more than four years. This was driven primarily by export vigour boosting industrial production, but it was also well-supported by a number of other economic pillars, including tourism and public expenditure.³⁸

Export strength in 2017 has persisted despite the rising baht (up approximately 8 percent in 2017)—this points to the inherent competitiveness of Thai exports vis-à-vis its trading partners and competitors. Strength will continue into 2018 as the global economy continues to gain momentum.

Private consumption will also shift into higher gear, as the mourning period for the late King Bhumibol Adulyadej has concluded. Furthermore, the reversal of farm income declines will add to steadily climbing levels of consumption. Private consumption will continue to be supported by robust tourism figures, with Thailand having welcomed 33–34 million international visitors in 2017.

A boost from the fiscal front will also materialise in early 2018 as large infrastructure projects, after some delays, are finally implemented. Rail, port, and airport projects will commence in the months ahead, adding to cyclical investment and demand while raising the long-term potential for economic growth. Significantly, private investment has been on a nascent upturn after an extended period of sluggishness—a broadening of growth into capital spending and private investment will give the economic upswing an extra boost.

Ranking of themes by importance for 2018: Thailand



Source: Deloitte and Centennial Asia Advisors Pte Ltd

The Philippines

The Philippine economy was firing on all cylinders in 2017 and all the indicators point to this continuing in 2018. Solid growth in remittances and business process outsourcing will provide a continued boost to domestic demand as well. The government is also ramping up public investment in infrastructure to alleviate supply-side bottlenecks and allow businesses to tap into commercial opportunities in outer regions. The share of public sector spending on infrastructure has increased by one percentage point of GDP since the current administration took over, and private investment looks set to continue as well. For example, Metro Pacific Investments Corporation plans to invest as much as USD 16 billion through 2022 on road, water, and power projects.

Monetary policy remains accommodative as the central bank is confident it can contain inflationary pressures. High credit growth is not yet a risk to the economy as the Philippines remains a lowly leveraged economy.

The current account balance may turn into a small deficit in 2018, but it is well funded by rising inflows of foreign investment and is driven by productive spending. Having depreciated significantly in the past two years, the peso is now competitive and unlikely to further depreciate materially.

Political risks remain contained as well. President Duterte has sought to rein in vested interests that have held the country back while also working for peace agreements with Muslim and Communist insurgents in the south.

Ranking of themes by importance for 2018: The Philippines



Source: Deloitte and Centennial Asia Advisors Pte Ltd

Malaysia

The economy is set to remain in a sweet spot and continue punching above its weight in 2018. As an open economy with a sizeable electronics footprint, Malaysia will be a clear beneficiary of the global cyclical upturn, which is expected to continue into 2018 with a pickup in capital spending. The government is also pushing ahead with ambitious infrastructure projects, which should improve competitiveness in the long term while providing the economy with considerable multiplier benefits in the next few years.³⁹

The implementation of necessary, albeit unpopular policies such as the goods and services tax and subsidy rationalisation points to an economy that is competently managed by the government. Going forward, more certainty and policy clarity is warranted, particularly on the government's blueprint for the future (that is, TN50) to provide a clear policy direction to steer the economy.

As growth improves, monetary policy will probably be tightened. However, with price pressures holding steady and the current account remaining in surplus, there is little need for a sharp tightening.

Still, there are risks to monitor. Structurally, the government has to consider long-overdue reforms in addressing issues weighing on the economy's competitiveness. The efficiency of government-linked companies (GLCs) needs to be improved while there is also a need to address human capital development to provide a fillip to productivity growth, particularly as Malaysia advances towards a high-income economy.

With general elections looming in 2018, there will be some uncertainty that could affect business confidence in the short term.

Ranking of themes by importance for 2018: Malaysia



Source: Deloitte and Centennial Asia Advisors Pte Ltd

Singapore

The Singapore economy has enjoyed a tremendous rebound since late 2016 on the back of buoyant global demand and resurgent trade flows, underlining the high dependency this open and export-oriented economy has on the global economy, particularly the import demand of advanced economies. External drivers have boosted economic growth to its highest levels since 2013, with global manufacturing powering the upswing.

While proceeding at a gradual pace, external positives are increasingly spilling over into domestic sectors, pointing to a broadening of the economic expansion that makes it more sustainable.

Going forward, growth is expected to be driven primarily by the continued strength in trade. Singapore will also be supported by second-order positives stemming from robust export growth and modest growth in services. The construction sector will gradually turn around as the Singapore government accelerates publicly funded projects to provide the beleaguered sector with some vigour.⁴⁰

As the economy gathers greater momentum, inflation surprises to the upside could become a concern should economic slack diminish and growth improve further. This means that monetary policy will likely be shifted in the next policy meeting in April 2018, from a neutral to a hawkish stance with a gradually appreciating slope. This will prevent the economy from getting ahead of itself and rein in potentially intensifying inflationary pressures.

Ranking of themes by importance for 2018: Singapore



Source: Deloitte and Centennial Asia Advisors Pte Ltd

Indonesia

The uplift in the global economy has not translated into a sizeable boost for the Indonesian economy, given that it is primarily driven by domestic demand. However, it has been helped by higher commodity prices. Lead indicators point to stronger growth in 2018, as improving business and consumer confidence as well as the cuts in interest rates over the past two years produce stronger domestic demand. Tourism is also likely to continue being a strong growth driver.

Foreign and domestic investment will also be helped by improvements in the business environment. The reformist government has been on the front-foot in improving the legal and investment climate, as evidenced by Indonesia’s quantum leap (19 places) in the World Bank’s “Doing Business” ranking.

The government is also developing alternative growth engines. In the tourism sector, the government is seeking to diversify its excessive dependence on Bali by building “10 Balis.” Infrastructure development—which, although at the heart of the government’s agenda, has been slow to take off—should begin to move faster in 2018.

Risks to domestic and external stability appear contained. Inflation remains at historically low levels. The current account deficit may grow as investment picks up but should be sustainably funded. The rupiah has remained remarkably stable as well.

While the next presidential elections are due in April 2019, the administration of President Joko Widodo has renounced populist measures whilst also clamping down on threats to secularism.

Ranking of themes by importance for 2018: Indonesia



Source: Deloitte and Centennial Asia Advisors Pte Ltd

Australia

Growth in 2017 was disappointing, but looking ahead, the outlook is more positive. Stronger global growth, particularly among Australia’s major trading partners, and the boost from infrastructure investment is expected to drive a modest pickup in growth. Furthermore, the drag from declining mining investment has now mostly played out.

While employment growth has strengthened and is expected to be a little higher based on indicators of further momentum from the labour market, wage growth is likely to remain below trend, which will continue to weigh on household incomes and consumption.

At the same time, high household debt continues to be a risk to macroeconomic and financial stability. While prudential policies have played a role in slowing housing credit growth and managing the systemic risks to the banking sector, developments in the property markets remain a concern, particularly in certain inner-city apartment markets.

On the other hand, inflation is expected to remain contained, so if housing market pressures can be managed, there is scope for monetary policy to continue to be accommodative. This, in addition to the flow-through from expected public infrastructure spending, should provide support to non-mining business investment.

Australia will remain particularly exposed to downside risks from China.

Ranking of themes by importance for 2018: Australia



Source: Deloitte and Centennial Asia Advisors Pte Ltd

New Zealand

Recent trends in global trade indicate New Zealand will remain in a sweet spot over the next year, with good prospects for trade as global growth picks up, almost a decade after the 2008 financial crisis. Overall, the Reserve Bank of New Zealand forecasts solid GDP growth (3.6 percent) in 2018, but efforts to cool the housing market and an expected reduction in net migration could potentially stall this progress. Additionally, a looming change in monetary policy away from solely targeting inflation could cause uncertainty in the outlook for the cash rate and inflation.

As the world's economic centre of gravity shifts towards Asia, underpinned by an emerging middle class and consumption-driven growth, New Zealand's relative proximity to Asia, combined with strong cultural and economic ties, will allow it to benefit through increased Asian spending on the following:

- Tourism is New Zealand's largest export industry and is projected to be one of the fastest-growing industries in the world. In 2018, New Zealand is expected to see increasing demand for tourism from Asia and greater impact from the sharing economy.
- Agribusiness is also expected to be among the fastest growing industries globally. New Zealand can be a long-term winner in agribusiness by focusing its strategy more on growing value than on growing volume.
- Advanced manufacturing has experienced significant growth in export earnings in recent years. In 2018, further growth is expected to be driven by health technology, in large part due to an ageing population and increased demand in agricultural technologies and other scientific technology.

Ranking of themes by importance for 2018: New Zealand



Source: Deloitte and Centennial Asia Advisors Pte Ltd

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