

Asia Business Outlook

May 2008

Asia, the best place to be economically ... for now

Every six months The Insight Bureau asks a group from within its resource network of Asian business specialists about their economic expectations for the next 18 months. Why depend on just one Asian economist when you can access several? With the benefit of a range of individual outlooks and forecasts, The Insight Bureau makes the following conclusions.

US OUTLOOK 2008: How serious is the US recession and how long will it last?

TIB's expert panel believes the US recession, being a consumer-led one, will be relatively shallow but long – lasting well into 2009. It will be the worst slow-down since the 1980s, at least, with the current decline in consumer spending only the first stage. Unemployment will rise later this year, cutting spending further. The worst is yet to come in 'the second half of 2008' says Yuwa Hedrick Wong. Banks and households will prioritise the rebuilding of their balance sheets over consumption and investment. We will see more mortgage defaults with house prices falling another 15-20% in the US. We will also see higher losses from credit cards, car loan defaults and personal bankruptcies. For some banks, it will be death by a thousand cuts.

The recovery will be slow and anaemic and will last much longer than in previous recessions. The weak dollar will help export oriented companies to recover first, although the slowdown in the construction sector will be especially prolonged.

'There is a 30% chance of a much darker outcome', says Robin Bew, 'in which the US could enter a Japan-style period of low economic performance.' In response to further consumer belt-tightening, companies could slash investment and cut employment further. This would result in an even more prolonged downturn in the US property market, with house prices continuing to fall into the next decade.

The proverbial resilience of the US economy will be severely stress-tested this time.

This edition of the Asia Business Outlook surveyed the following panel:

Robin Bew	Editorial Director/Chief Economist, Economist Intelligence Unit
Manu Bhaskaran	Chief Executive, Centennial Asia Advisors
Daniel Franklin	Executive Editor, <i>The Economist</i>
Yuwa Hedrick-Wong	Economic Advisor, MasterCard International Worldwide
Adit Jain	Managing Director, IMA India
Victor Mallet	Asia Editor, <i>Financial Times</i>
Graeme Maxton	Asia Commentator, Contributor to <i>The Economist</i>
Jim Walker	Founder & CEO, <i>Asianomics</i>
Pam Woodall	<i>Asia Economics Editor, The Economist</i>



Manu Bhaskaran Singapore Robin Bew London Pam Woodall Hong Kong Jim Walker Hong Kong Graeme Maxton Hong Kong Yuwa Hedrick-Wong Singapore Adit Jain New Delhi Daniel Franklin London Victor Mallet Hong Kong

EUROPEAN OUTLOOK 2008: What is the probability of a recession?

The panel saw less risk of an overall recession in Europe, although there will be a slowdown, which will be especially bad in some countries and for some sectors. There will be 'particular problems where the housing boom has been strongest, such as the UK, Ireland and Spain', says Daniel Franklin. But the impact on these economies should be less serious than in the US, because households have not borrowed against their capital gains to the same extent as American households. Businesses which are most dependent on dollar revenues or on exports outside the region will suffer. Importers will gain because of the stronger euro. For most countries and sectors though, inflation is still a bigger concern than growth for now. There are, however, much greater risks of a recession in the UK, Ireland, Spain and Italy than Europe as a whole.

The ECB is expected to keep interest rates on hold for the time being but may cut them later in the year. The euro will stay high against the US dollar. The strength of the euro is not doing as much damage as many people believe because most of Europe trades with itself. The greatest damage will be felt in the least competitive economies, such as Spain and Italy. In Germany, firms remain generally optimistic, although sales are increasingly being directed away from the US and into fast growing Asia.

THE GLOBAL FINANCIAL CRISIS: After Bear Stearns, will there be others?

The financial write-downs in the US will worsen, perhaps even double. Those in Europe will rise even more and there will be many more banks needing to be recapitalised. 'There will also be banking casualties in Eastern and Central Europe and in the Icelandic banks' says Graeme Maxton; In contrast, Asian financial institutions will remain in relatively good shape.

'What we need to remember is that the recession proper has barely started yet', says Jim Walker. 'Corporate loan defaults, credit card defaults and personal/company bankruptcies will all climb'.

DOLLAR / EURO: What is the forecast for the end of 2008?

Most of the panel members with extensive experience in Europe believe that the dollar/euro exchange rate will be around 1.55-1.65 by the end of 2008. This means that the euro will fall but still be at a historically very strong level, and close to the limits of political tolerance in Europe. But, assuming US interest rates do not fall any further, there will be less inclination to continue selling the dollar in the coming months. The dollar's decline in the last few years already amounts 'to the biggest default in history', says Pam Woodall. 'It has wiped far more off the value of foreigners' assets than any emerging market has ever done. And, no matter what happens, this is the beginning of the end for the dollar as the main reserve currency.'

But the expert panel at TIB was very divided on this subject. One member of the panel, who believes that the euro area is much more vulnerable to a recession, predicted the euro weakening to 1.30 by the end of the year. Others agreed, however, that the euro is currently overvalued. In contrast, another member pointed out that a much deeper decline in the dollar is still possible, if there is a more generalised loss of confidence in the US economy and in the US financial system. If that occurs, there is no obvious floor under the currency and so rates approaching \$2.00 to the euro could be possible. This is an extreme case with a low probability but could come about were the US to enter into a Japan-style stagnation.

DOLLAR/YEN: What is the forecast for the end of 2008?

The consensus of TIB's expert panel was that the dollar/yen exchange rate would end the year between 90 and 100 yen to the dollar. Most of the fall will happen over the next few months, with the dollar stabilising once the market realises that US rate cuts have come to an end.

CHINA'S GROWTH: What is the economic outlook for 2008?

'China's growth so far this year has proved surprisingly robust', says Victor Mallet. However, with Chinese inflation leading to credit tightening, rising cost pressures and falling profit margins in many industries as well as slower export growth, the rate of economic expansion will slow to about 9% in real terms in 2008. It will slow most sharply in the second half of 2008. With the RMB appreciation, those export sectors that are particularly dependent on the American market will be seriously squeezed. So China's trade surplus will shrink in 2008 as export growth slows. However, total exports will not collapse as falling exports to the US are being offset by a boom in exports to other emerging economies. Net exports will account for 3-4% of GDP growth in 2008 as opposed to the 6-7% level in the recent past.

Job creation will slow to about 9 million a year down from the 11 million annual average of the past few years. Fiscal spending will pick-up in China; with accelerated infrastructure investment, especially in the interior and lower income provinces. This will benefit markets like Indonesia which exports resources, as well as Japan and Korea which export heavy industrial machinery and related capital goods.

CHINA INFLATION: How high will it reach in 2008 and who damaging is this?

'Inflation in China is not likely to exceed 9%', says Manu Bhaskaran. The rate of inflation has scared policy makers and will force them to act. There are hidden inflationary pressures but also informal and formal price caps and controls imposed by local governments which will keep it in check.

Imported inflation will experience a decline in some segments as Chinese demand for raw materials and components falls and the country builds its own supply capabilities. Slower economic growth will also dampen demand. Imported inflation will also be suppressed by a faster rising RMB exchange rate against the US dollar.

On the other hand, rising wages, new labour regulations, new environmental regulations, higher input costs are all pushing companies to raise prices. Easier monetary conditions, which support end-user demand, allow companies to have pricing power too. But rising inflation and a loose monetary policy has led to negative real interest rates at both the lending and deposit levels. These in turn encourage flawed investment decisions fuelling growth and leading to even faster inflation.

Expect further appreciation of the RMB in 2008 too, perhaps by as much as 15%. This will squeeze the margins of Chinese exporters forcing some to relocate to Vietnam or inland. Companies may then accelerate their move up the value-add and technology ladders.

SOUTHEAST ASIA: What is the outlook for 2008?

The prospects are for generally slower growth in the region in response to global economic deceleration. As China slows, the rest of the region will slow too. Hong Kong, Malaysia, Taiwan and Korea are most at risk. Smaller economies such as Singapore, Malaysia and Taiwan, which are more dependent on US demand, are also likely to see a sharper slowdown in growth, however nowhere near as severe as in 2001.

All the economies will slow with lower exports to the US, rising inflation and declining consumer confidence. Compared to the rest of the world, each country will still experience healthy growth of 3-4% or more. All governments have reserves they can invest to boost their economies and several are also rich in commodities and so will see some sectors of their economies continuing to boom.

Singapore: resilient as construction remains vibrant, after interest rates have fallen, new investments in large new plants coming on stream.

Malaysia: 9th Malaysia Plan spending peaking but political uncertainty is hurting domestic demand, compounding effect of slower world growth.

Indonesia: benefiting from higher commodity prices, the effect of previous rate cuts, easier fiscal policy. But vulnerable to rising inflationary expectations and exchange rate fears.

Thailand: release of pent-up demand as political uncertainty has been reduced. Exporters have been nimble enough to divert exports to newer markets.

Philippines: moderate slowing as remittances and global demand slow. Rising food prices and inflation could increase political turbulence.

Vietnam: Strong growth from more FDI, lagged positive effects of reforms, oil and commodity prices. But inflation is a major risk.

Longer term, there are other concerns. External trade has been the main growth driver and poor policy management means that Indonesia and Malaysia in particular will have to tighten their belts this year to avoid inflationary problems. Strip out the commodities windfall for countries such as Malaysia and Indonesia and the picture is less bright still. Sustainable rates of economic growth have fallen since the cleanout of the Asian crisis in 1997-98 and policy-makers need to embark on some vigorous economic reforms are required in many countries if they want to return to higher and more sustainable growth in the long term.

INFLATION TRENDS IN THE REST OF ASIA: How do these markets differ?

Inflation will be a key challenge for South East Asia, South Korea and India in the coming years. Non-tradable inflation – rising prices of goods and services that are not traded – is rising especially strongly in countries such as Singapore, Korea and Taiwan. Throughout the region, inflation will rise because of higher food prices and higher commodity prices. Rising wages will play a large part too. The pressures will be offset slightly by a weak dollar relative to many Asian currencies and slowing rates of economic growth.

Many of the effects of this rising inflation will be difficult to predict as governments will introduce price controls or limit trade in foodstuffs to keep the prices of basic goods from rising further. The traditional offsetting policy of currency depreciation to boost a slowing export sector is not going to be easy however, for fear of importing inflation. Hong Kong is especially at risk here, with its currency peg to US\$, followed then by Korea.

'In India, high economic growth has generated huge demand with supply side shortages', says Adit Jain. The country is also suffering from some asset bubbles, notably in some real-estate sectors. Adding to the inflationary pressures has been massive spending in government welfare schemes. Food prices have increased locally by about 40% against last year's rise of some 10%.

Throughout much of the region there is a growing concern that further expectations of inflation mean that it will become increasingly 'embedded' and become a longer term issue.

JAPANESE ECONOMY: What is the outlook for 2008?

Lacklustre. Political uncertainty and lack of policy leadership, slower global demand and a stronger yen will all hurt Japanese growth prospects. Moreover, Japan's lack of room for policy manoeuvre makes it vulnerable. Not only are interest rates ultra-low, Japan also has the sickliest public finances in the developed world. It has no room for fiscal loosening. Worse, the yen's sharp against the US dollar and sluggish growth make Japan vulnerable to a renewed deflationary shock. Interest rates will stay low but the appreciation of the yen will make yen-based carry trades less attractive. Only a recovery in residential construction (from the slump caused by the botched introduction of new building rules in 2007) will offset the effects of the slower export growth, we anticipate.

INDIA'S OUTLOOK: What is the outlook for 2008?

India's economy will slow – from 9% to about 6%-7% this year. The stock market, which is down 20% so far this year, is not expected to recover by end 2008 largely because it was over-owned in the first place. Falling markets create a negative wealth effect which curbs retail spending. So consumption will fall, with the automotive sector, real-estate, consumer durables, consumer electronics, textiles all expected to decline. The budget deficit also makes it hard for the government to stimulate the economy. It has blown the budget on subsidies for fertilisers, food and fuel. The strong currency will also hurt exporting sectors of the economy. Poor agricultural performance will dampen rural demand and the falling stock markets will hurt urban sentiment. Worse, the stock market remains vulnerable to a further reversal of foreign inflows as well as to earnings downgrades.

On the brighter side, one area that may benefit from the crises in western banking is outsourcing; a possible way for the big banks to cut costs is to move even more of their back-office workload to India. This will be tempered, however, as the country's declining cost-advantages and the growing lack of skills.

SOUTH KOREA & TAIWAN: How will the new presidents shape their economic fortunes this year?

Fiscal spending in Korea will rise and infrastructure investments will help offset external demand weaknesses. But Korean officials seem willing to take risks with inflation and the currency. Moreover, Mr. Lee's infrastructure plans look suspiciously like Japanese-style gifts to the construction industry. He needs to do more to encourage the rise of smaller companies and the entry of foreign investors.

In Taiwan, President Ma will bring better relations with the PRC and a clearer economic policy, which will be hugely positive. Weaker demand for its technology exports will be significantly offset by more business and consumer confidence domestically and the beginnings of inflows of Chinese tourists and investors.

INVESTMENT: Where is it safe to invest your short term liquidity needs?

One of the ironies of the credit crunch is that cash should be king and those with money to spare should be earning exceptionally high rates of interest. Instead, central banks – especially the Fed - are penalising savers to rescue the banks. This means, bizarrely, that it still makes sense to invest in the overvalued Hong Kong property sector using borrowed money.

In the end, with failing banks and so many risks around the world, our panel was pretty unanimous about where is safe:

- ◇ For those in Asia – Singapore dollars
- ◇ Environmental investments – in such areas as solar energy and energy saving devices
- ◇ Government bonds
- ◇ Utilities, telecoms and consumer staples

FINALLY, WHAT KEEPS YOUR PANEL AWAKE AT NIGHT, ECONOMICALLY SPEAKING?

It is an old joke that if you ask two economists a question you'll get four opinions! However, our panel of nine this time was generally in agreement. There are a few items that keep almost all of them awake at night, and most were related to some sort of aftershock to the 'credit crunch' which would bring about a global recession:

- ◇ A systemic collapse of the European and US banking systems
- ◇ Uncontrolled food price inflation leading to starvation in the Developing World
- ◇ Counterparty failure in the credit default swap market
- ◇ Stagflation setting in
- ◇ The US blaming China for its economic woes and making everyone more protectionist

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