

## **Asia Business Outlook**

October 2007

Every six months The Insight Bureau asks a group from within its 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.

### **What is the economic outlook for the US, Japan and Europe in the next 18 months?**

#### **The US**

The US economy will slow markedly with GDP growth easing to about 1.7% in 2007. We expect a recession with a recovery in the second half of 2008. The key contributing factors are a weakening dollar, downturn in the housing market, significant contraction in the credit market, and slower consumption. Growth for 2008 will be 0.8%. Even with a comparatively short recession, the impact will be felt globally with Japan and Europe's growth slowing too. There is also scope for a more prolonged recession with many downside risks. A more serious recession would have much more serious global implications and a much more significant impact on Asia. This is not our central forecast, however.

#### **Japan**

As US consumer demand weakens, Japan's already faltering recovery – which has relied heavily on US import demand– will drop back again as the strengthening yen and falling dollar cut trade. With little chance of real economic reform, weakening economic sentiment and anaemic demand, Japan's economy will perform poorly for several years. GDP growth for the world's second biggest economy in 2008 is expected to be just 1%.

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

Robin Bew	Editorial Director/Chief Economist, Economist Intelligence Unit
Manu Bhaskaran	Chief Executive, Centennial Asia Advisors
Prof Fan Gang	Director, National Economic Research Institute, China
Yuwa Hedrick-Wong	Economic Advisor, MasterCard International Worldwide
Adit Jain	Managing Director, IMA India
Guy de Jonquières	Asia columnist, formerly with the <i>Financial Times</i>
Graeme Maxton	Asia Commentator, Contributor - <i>The Economist</i>



Adit Jain  
New Delhi

Guy de Jonquières  
London

Manu Bhaskaran  
Singapore

Graeme Maxton  
Hong Kong

Yuwa Hedrick-Wong  
Singapore

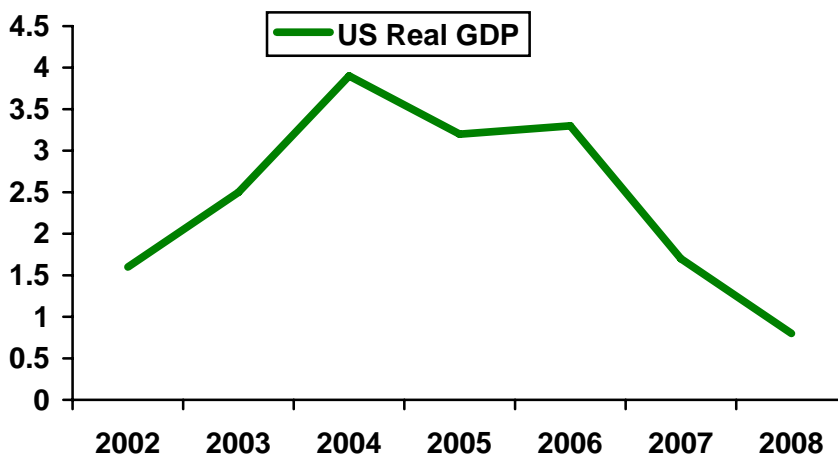
Robin Bew  
London

Fan Gang  
Beijing

## Europe

Growth in Europe will be negatively affected by the US economic slowdown and global credit and liquidity problems. Yet while the “financial turbulence will take a toll, European growth is likely to out-perform both the US and Japan” says Manu Bhaskaran, a board member with the Centennial Group. GDP growth of 1.5% is expected in 2007 and 2% in 2008. Europe is expected to emerge as the strongest and most resilient among the three key economies of US, Japan, and Europe, largely by default.

Chart of US growth 2002-2008, %



Source: published sources, TIB. Actual 2002-2006, remainder forecast

## What is the economic outlook for China, India and the rest of Asia?

### China

China's economic growth will remain the strongest in Asia at 11.5% in 2007. With the slowdown in trade to the US, the rate will slow to 9% in 2008. Paradoxically, as the government still needs to focus on cooling the economy, China is likely to see a global slowdown as a good thing. It will help reduce the trade surplus and may cut domestic inflationary pressures – although this remains an area of concern for us. Commodity prices are expected to remain high and so while domestic inflationary pressures will ease, China risks importing new ones. Overall though, “the slowdown will be welcomed by the Chinese government and planners” says Yuwa Hedrick Wong, an economic advisor with MasterCard.

With plenty of room (and money) for expansionary policies, domestic demand will remain a key part of the economy. Exports will switch more towards Europe (assuming there are no trade problems) and to other Asian markets. There are two main threats however: that spiralling food prices, due to high import barriers and agricultural self-sufficiency policies – will not respond to tighter monetary policy and will prompt social unrest; and that there will be a stock market collapse. The main victims would not be small retail investors but SOEs, whose profits increasingly depend on punting cash on the stock markets. The danger is that a serious stock market reverse could become self-reinforcing, as both sources of investment and apparently ever-rising profits dry up.

## **India**

The monetary tightening last year is having an effect with industrial production slowing. At this stage, we expect a largely cyclical slowdown. Projections are for India to grow by 7.5% in 2007 and ease back to 6.5% in 2008. Although not as exposed to the global market as China, sentiment here can be especially fickle. Mumbai's stock market is also vulnerable to the unwinding of the yen carry trade and the country remains overly dependent on short-term foreign inflows to finance growth. These are likely to drop back. The structural drivers of long term growth remain in place however – a huge pipeline of capital spending by companies, a very gradually easing infrastructure constraints and continued competitive positioning in business outsourcing as well as in some manufacturing niches such as pharmaceuticals and engineering.

## **The rest of Asia**

The rest of Asia's economic growth should remain strong in the next 18 months although there are risks from the weakening US market for Asia's export and China's increasing ability to substitute for imports from the rest of Asia.

## **What will happen to the value of the US dollar, the Euro and the Yen?**

### **The US dollar**

The US dollar will continue to decline as US interest rates soften. It is expected drop to around 1.50 USD to the Euro, with a worst case of 1.70 by mid-2008.

### **The Euro**

Expected to end 2008 at 1.40 to the USD

### **The Yen**

Expected to gain against the US dollar due to the slowdown in capital outflows and unwinding of the carry trade to 105 yen per USD by the end of 2008 with a worst case of 95. The Bank of Japan will need to raise interest rates throughout the next 18 months.

## **Which industrial sectors do you expect to perform best in Asia in the next 18 months and least well?**

### **Best performing Industrial Sectors**

Non-cyclical and non-export dependent sectors such as utilities, telcos, steel, pharmaceutical, automotive, and construction should fare the best in the next 18 months. "Domestic-orientated sectors will perform better than those aimed at feeding US demand" says Robin Bew the Editorial Director of the Economist Intelligence Unit. In countries outside China, industries aimed at supporting Chinese domestic spending will do well. Japanese car makers are expected to perform well, gaining market share at the expense of US and Chinese rivals, even if US volumes are lower. In China, fast-moving consumer goods as well as infrastructure and related commodities sectors will perform well.

### **Poorest performing sectors**

Sectors such as electronics and those that are export dependent (especially to the US) are not expected to perform as well.

### **What are the greatest challenges facing businesses in Asia over the next 18 months?**

The biggest concerns of the economic panel were:

- Rising trade protectionism in both the US and western Europe
- Managing currency fluctuations, especially the weakening US dollar
- Sustaining domestic consumption in Asia
- The shortage of skilled staff -- expect wages to continue soaring
- And, “the China asset bubble” says Prof Fan Gang, Director, National Economic Research Institute in China

### **Will central banks in the US, Europe and Japan continue to flood the market with over the next three months? If so, how effective will this be?**

The issues facing many financial institutions (excess debt and devalued assets) are ones of solvency, not liquidity. Cutting interest rates and increasing liquidity may boost demand but it will only support sentiment temporarily. “False liquidity injections are nothing more than economic Botox” says Graeme Maxton an independent Asian Commentator and contributor to The Economist. Although they may reduce the speed of decline in financial markets, they will not prevent a substantial weakening in economic performance or the dollar. Worse, “pump-priming risks higher inflation” says Guy de Jonquières an Asian columnist with the Financial Times. Adit Jain of IMA India agrees, “The Fed is, and should be, primarily concerned with price stability”.

### **Finally, we asked what issues kept the panel awake at night, economically speaking?**

The top worries were;

- central bankers opening the liquidity flood-gates leading to global inflation
- a debt-deflation spiral that will drive the US and Europe to dump assets to meet margin calls, forcing a generalized re-pricing of risk and a prolonged period of stagnation (as Japan experienced in the 1990s).
- a major drop in the value of the US dollar
- “The impact of a more serious US recession could trigger a much darker outlook for Asia”, concludes Robin Bew, Editorial Director of the Economist Intelligence Unit

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For further information, contact: Andrew Vine, Managing Director, The Insight Bureau Pte Ltd  
#15-01 Prudential Tower, 30 Cecil Street, Singapore 049712  
Tel: +65-6300-2495 / email [engage\\_us@insightbureau.com](mailto:engage_us@insightbureau.com)

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