Asia Pacific economic outlook

September 2009
A Deloitte Research report

Outlook for Select Asia Pacific Economies

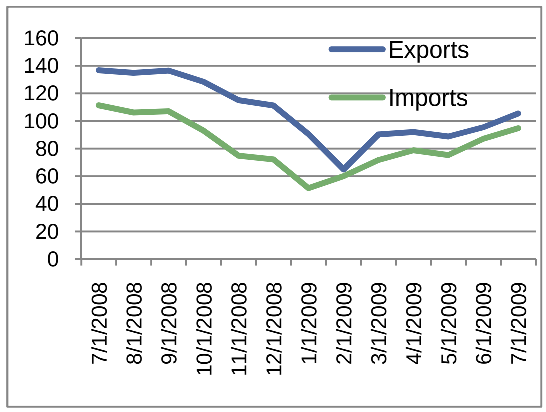
China

It was said that an increase in consumption in China, and not the United States, would fuel global exports and economic growth. The nascent economic recovery we see now appears to confirm this hypothesis. Most of the Asia Pacific economies have benefited from the strong economic growth in China in the second quarter. The Reserve Bank of Australia's monetary policy statement notes the contribution of China to the "comparatively good performance" of the Australian economy: "Finally, the strong recovery in China, which has boosted commodity prices and demand for Australia's exports, has also been important. While most countries have recorded declines in export volumes of at least 10 per cent since September last year, Australia's exports are estimated to have recorded a small rise over this period."

The experience so far, however, raises further questions. One, is China likely to continue to grow at a good enough pace this year to act as the engine of growth? Two, is the Chinese economy rebalancing toward domestically driven growth?

These two questions overlap at some level. Given that there is not much hope of export-led economic growth in the current international environment, growth has to come from domestic demand. It is happening — domestic demand has been the main driving force for the 7.1 percent economic growth in the first six months. Retail sales are growing faster than the disposable income of households, and imports increased (MoM) to narrow the gap between them and exports, reducing the trade surplus. The momentum for growth has, however, not come as much from private consumption as from public investment, with investment in fixed assets increasing by more than 33 percent in the first six months compared to the same period last year. This means that though increased consumer spending has taken up some of the slack in exports, the economy has not yet rebalanced away from a dependence on exports in the real sense. The implications for economic growth in the near-term are clear. Fiscal stimulus and easy monetary policy will be the cornerstones of continued or accelerated growth in the next quarter.

Monthly Exports and Imports



Source: Bloomberg

This brings us to the question of growth: what to expect in the next quarter? There is a real possibility that, as projected by the government, economic growth may accelerate to 8.5 percent in the third quarter, fuelled by the fiscal and monetary stimulus. Public investment, the main driver of growth, is expected to grow at the same pace through the next quarter. The purchasing managers' index (PMI), which increased to 52.8 in July, points to an expansion in the economy, as does the second quarter reversal in the declining trend in machinery output.

There are two issues that could potentially result in a slackening of pace. The sharp slowdown in bank lending in the month of July raised concerns that the People's Bank of China (PBC) may be calling an end to the party prematurely, creating fears of a deceleration in economic growth. Subsequent clarification from the Governor of the PBC, Zhou Xiaochuan, suggests that the “moderately easy” monetary policy will continue and that lending will bounce back. Banks have already lent out $7.7 trillion yuan till July, which means some slowdown in lending is to be expected. This need not be interpreted as a tightening of monetary policy, and will likely not have a huge negative impact on growth.

The other concern is that increased investment is adding to existing excess capacity in some sectors, which means that, at some point, growth has to shift to consumption, domestic or foreign, instead of investment. Without a rise in consumption, correcting for excess capacity would mean reduced growth. Raising domestic consumption to fill in for exports would at some point require revaluating the yuan. A revaluation, however, does not seem probable. It is likely that China will keep the yuan stable, use the fiscal and monetary stimulus to sustain the economy, and hope for a recovery in world demand at some point to support the increase in consumer spending that is taking care of the excess capacity.

China remains the main hope for the world economy to recover from the current slump, and it is likely to deliver substantially with growth expected to accelerate in the second quarter.

Japan

First, the good news: Japan appears to have come out of the worst postwar recession, the third G7 country to do so. The growth of 0.9 percent in the second quarter comes on the back of a 3.1 percent decline in the first quarter. If this rate were maintained for the entire year the economy would grow at 3.7 percent, which is better than the performance of all other major economies so far.

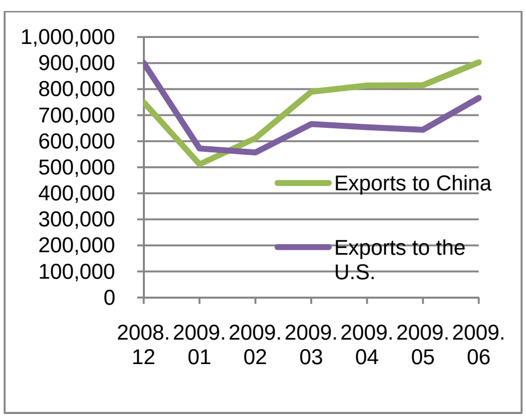
The real question, however, is whether the good news will last. The current recovery has brought back the worst memories of the “lost decade” when the economy showed signs of a recovery only to falter again. Record unemployment, falling wages and a decline in business investment have kept the mood somber. The accelerated decline in the “core-core” index of consumer prices (excluding food and energy) in the month of July increased fears of the economy being caught in a deflationary spiral that will continue to eat into the profits of manufacturers. The Bank of Japan expects that it will take “considerable time” before prices stop declining.

There are, however, some positive indications. The PMI, in the positive territory for the first time in 17 months, rose to 50.4 in July, which has boosted confidence in the continued expansion of manufacturing output. Further, the decline in the ratio of inventory to actual shipments suggests an improvement in the operating conditions of manufacturing firms.

In the short term there are two beacons of hope for continued expansion of the economy: fiscal stimulus and exports. Riding on these two, the economy is unlikely to revert into recession in the next two quarters, though much slower growth is more likely. The rise in consumer spending by 0.8 percent for the first time in three quarters and the continued increase in consumer confidence despite the worsening job outlook shows that the fiscal stimulus is working and will likely continue to hold up demand through the rest of the year. The landslide victory of the main opposition party, Democratic Party of Japan (DPJ), may create short-term euphoria and further shore up demand for some time, more so because it is likely to announce another round of stimulus spending. DPJ had promised better social welfare to boost domestic demand.

Japan's economy has become increasingly dependent on exports in recent years. The current recovery also owes a lot to exports, which grew for the first time in five quarters, thanks to the massive stimulus spending programs launched by governments across the world, especially China. The number of passenger cars exported in the month of June increased by 31 percent over the previous month, more than 4 times the growth. With better news coming from the United States, and the expectation of further acceleration of growth in the third quarter in China, there is hope that exports may continue to grow. The recent strengthening of the yen against the dollar, however, has worried exporters. The yen may continue to strengthen, given that the DPJ has proclaimed a non-interventionist policy in the currency market. A stronger yen, coupled with a dip in the world economy and demand will likely affect Japan's nascent economic recovery adversely. A strong revival in world demand, on the other hand, may offset the impact of a stronger yen.

Monthly Exports to China and the United States (Million Yen)



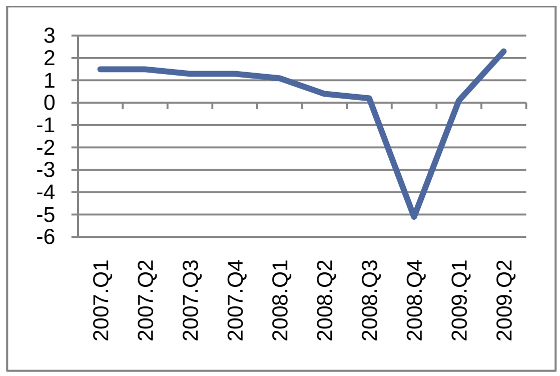
Source: Statistics bureau, Japan

Overall, a delicate and level growth trajectory for the next two quarters is in the cards, unless the major economies of the world fall back into another trough.

South Korea

The fifth largest economy in the Asia Pacific region has a habit of surprising forecasters with its tendency to rebound strongly from recessions. It did so when it registered a stunning 9.5 percent growth in 1999, right after the East Asian financial crisis. It did it again in the second quarter this year: the 2.3 percent growth over the previous quarter equates to a 9.7 percent annualized growth rate, resulting in what appears to be a strong v-shaped recovery.

Real GDP Growth (QoQ)



Source: The Bank of Korea

The economy appears to have nowhere to go but up. Inventory adjustments have come to an end and production growth has picked up in response to a strong growth in consumption. Machinery orders, a leading indicator, and machinery shipments registered strong positive growth in June for the first time in more than nine months, which complements the improving business sentiment reflected by the business survey index. Private consumption, which had dragged the economy down in the last quarter of 2008, rebounded strongly to grow at 3.3 percent (QoQ) in the second quarter this year. Consumer confidence has risen to a seven year high of 114 in August (a value above 100 suggests expansion) suggesting that the recovery is likely to be sustained.

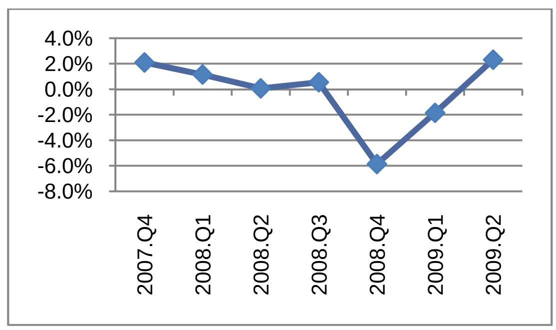
The Bank of Korea (BOK) is upbeat about the economy returning to positive growth in the second half. It now expects the economy to contract only by 1.5 percent in the entire year, which is significantly lower than the earlier estimate of 2 percent in April. However, it did drop a note of caution: "There still remains uncertainty as to the economic growth path due to the likelihood of delay in the recovery of the major advanced economies." There is reason to be cautious. The sharp rise in exports (by 11.2 percent QoQ), helped by the weak won and an uptake in demand from China, may not be sustained given that the world economy may take some time to return to normalcy. The fiscal stimulus, which had a role to play in the improvement in private consumption, was relatively frontloaded and is likely to lose steam toward the end of the financial year. It is not surprising, therefore, that the BOK decided to continue with an accommodative monetary policy in August with base rate at a record low of 2 percent to continue providing monetary stimulus. This decision has been helped by the fact that consumer price inflation is much below its target band of 2.5–3.5 percent. It is likely to keep this stance for the rest of the financial year.

The caution notwithstanding, Korea seems to be well on the path to economic recovery and sustained improvement in GDP, even if the extraordinarily good second quarter performance is not sustained at the same pace. Exports will be helped by a relatively weak currency. Though the won has strengthened since March 2009 as investor confidence returned with rising current account surplus and improved external credit situation for banks, it could still weaken because investors remain wary of risks. The recent tax reforms — such as the lowering of corporate income tax rates, tax protection for self-employed rebuilding from bankruptcy and generous R&D incentives — are likely to have a positive impact on corporate investments. Korea has a low debt-to-GDP ratio, which means that fiscal deficit is not a worry and improvement in economic conditions will only result in a better than forecast fiscal situation. In short, it wouldn't be a big surprise if the economy performs much better than the forecast.

Thailand

Thailand mirrored Korea's growth performance of 2.3 percent (QoQ) in the second quarter, after two quarters of sharp contraction, as the manufacturing and construction sectors grew at more than 6 percent. The comparison, however, cannot be stretched too far. Thailand's recovery is far more precarious and will require a number of factors to go right for the performance to be sustained.

Real GDP Growth (QoQ)



Source: Bloomberg

The slump in the economy had as much to do with the global recession as with the uncertain domestic political situation in the last quarter of 2008, which led to a sharp fall in exports and tourism, key sectors of the economy. The first stimulus package of nearly 117 million baht ($3.3 billion) has been instrumental in the current recovery, as was the sharp reduction in the benchmark interest rate by the Bank of Thailand (BOT) to 1.5 percent by April 2009. Though exports continued to decline, albeit at a slower pace than in the first quarter, a strong growth in government consumption expenditure coupled with a 0.8 percent increase in private consumption helped sustain demand.

There are some serious concerns about the economy, including political uncertainty that could continue to dampen investment and tourism. Banks are concerned about deterioration in asset quality and a surge in nonperforming loans, which has had a dampening effect on lending, especially to small and medium enterprises. Exports, which account for a fifth of the GDP, remain an area of concern. Thailand's key trading partners are the United States, the European Union and Japan. Growth in exports is dependent on an economic recovery in these countries. China has, to some extent, filled the gap created by the reduced demand from the United States, but not entirely.

Government spending can help keep the economy buoyant while the export markets still remain suspect. The 1.06 trillion baht (or nearly $31 billion) public investment package approved by the cabinet in mid-August, if properly implemented, will play a critical role in sustaining the recent recovery. The BOT is likely to keep the benchmark interest rate at 1.25 percent for the entire fiscal year as inflationary expectations remain subdued, and more so because it still expects the economy to contract by 3 to 4.5 percent. It may also try to weaken the baht to encourage exports and tourism. Newspapers have reported that the chairman of the Board of Governors of the BOT recently advised the government to take steps to weaken the currency. The currency is trading at close to 34 to a dollar, while the preferred value may be closer to 36.

Barring major political turmoil, the economy appears to be stabilizing from the lows of the last quarter of 2008. A strong revival in exports could help the economy return to the path of growth next year, as would signs of political stability. The third quarter figures will likely shed more light on the path of recovery.

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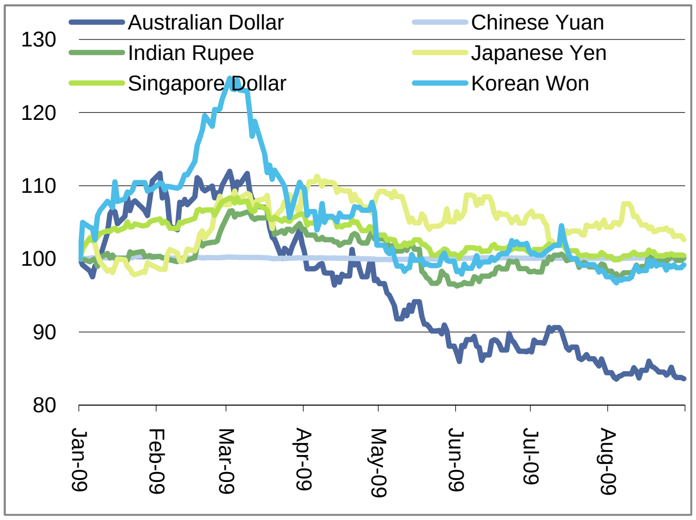
Select Economic Indicators

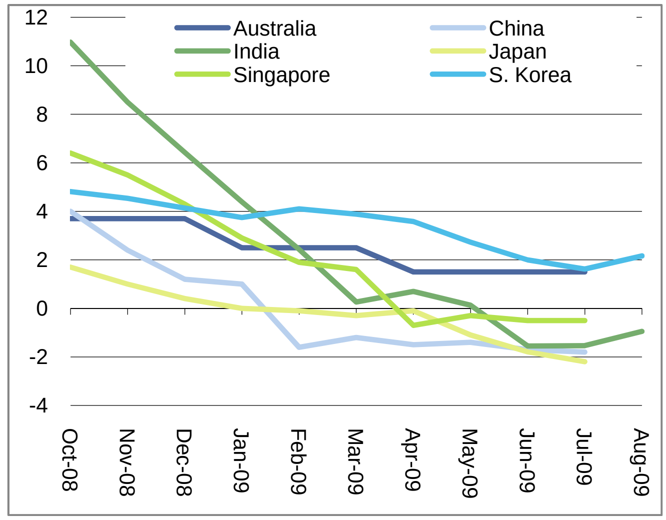
Indexed Daily Movement of Major Currencies (Jan 1, 2009 to August 31, 2009)



Source: Bloomberg

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

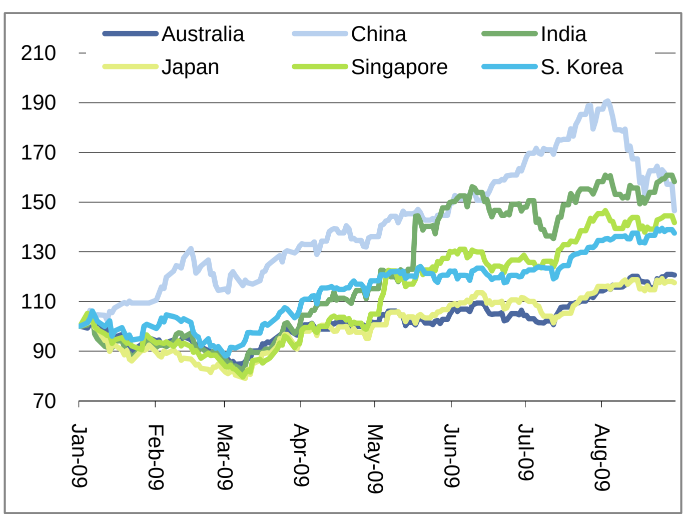
Inflation Rates



Source: Bloomberg

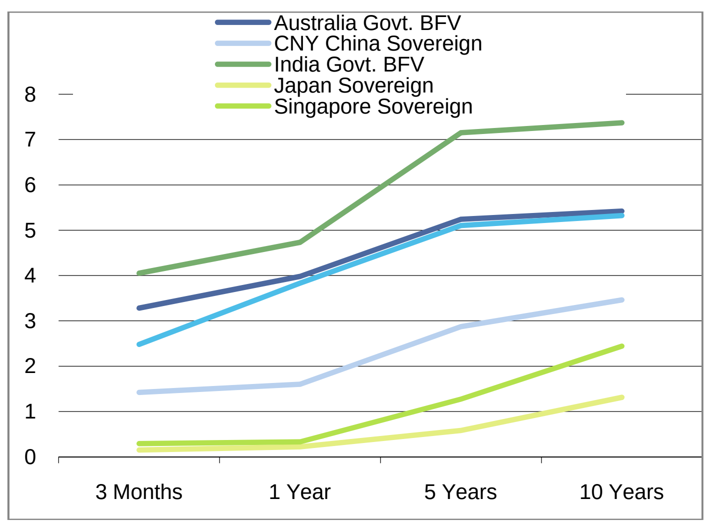
Note: Australia's inflation rate is a quarterly rate. India's is a weekly rate that is averaged.

Indexed Daily Movement of Major Stock Exchanges (Jan 1, 2009 to August 31, 2009)



Source: Bloomberg

Yield Curves*



Source: Bloomberg

* As on September 2, 2009

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