



Asia trip report 2008

September 8, 2008

Caught between high inflation and slowing growth

For the 16th time I embarked on my annual month-long trip to Asia in August. The weather was better than in past years, there was more sun and more blue skies. But the Asian economies are facing tougher conditions than in earlier years.

The slowdown in developed markets will have an impact. While Asia will continue to top global growth rates, they will decline this year and next as demand from the developed world retreats and China moves towards a lower trend growth rate.

Inflation is of serious concern, but central banks' approaches differ. Most inflationary pressure stems from record-high food and fuel prices, especially in lower-income countries. Often, political considerations lead to price distortions, creating waste and inefficiencies. And central banks diverge in their approach to fighting inflation.

High commodity prices are here to stay, creating winners and losers. Owners of commodities will enjoy a bonanza for ten years or longer. Consumers will pay dearly. Energy efficiency and renewable energy will be rewarding projects, and Germany and Europe can contribute to speeding up adjustment processes.

Political risks are rising in a range of countries. Recent elections and political changes have not always brought stability and terrorism is far from disappearing. High inflation raises political risk as well, and ethnic and/or religious strife is on the rise.

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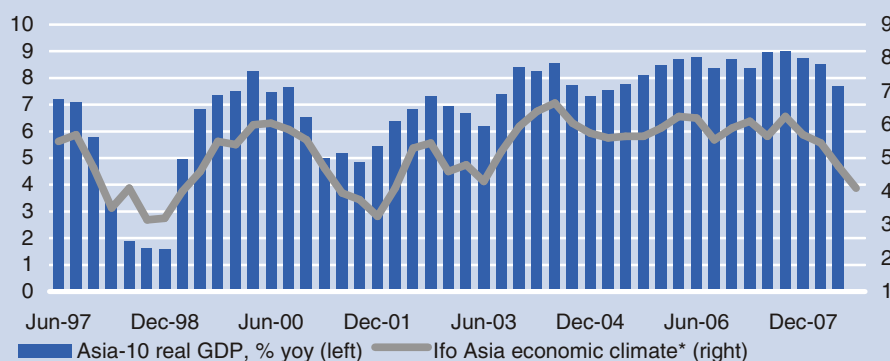
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Asia: Indications of a further slowdown



*ranges from 1-9, values below 5 indicating negative trend

Sources: Global Insight, ifo

August from Karachi to Tokyo again meant a hot and humid environment, but more sun and blue skies than in many earlier years – and not only in Beijing. On balance the region is still growing relatively strongly, with speed only lost in some countries that are heavily dependent on the US. There are some negative surprises: one is the setback in Vietnam, a country endowed with everything to be a star performer. It boasts a quality labour force, location next to dynamic China, favourable endowments for a range of agricultural products in high demand. But governance problems have clouded the growth outlook and hit the stock market. Nonetheless, the favourable facts mentioned above should serve as driving forces to rekindle better economic performance. Another nuisance is the political uncertainty in Thailand. The new government is challenged in the streets and the offices. Checks and balances in the constitution still leave a lot to be desired. This does not make economic life any easier at times when emerging market risk premia have risen.

One year into subprime – financial crisis still on

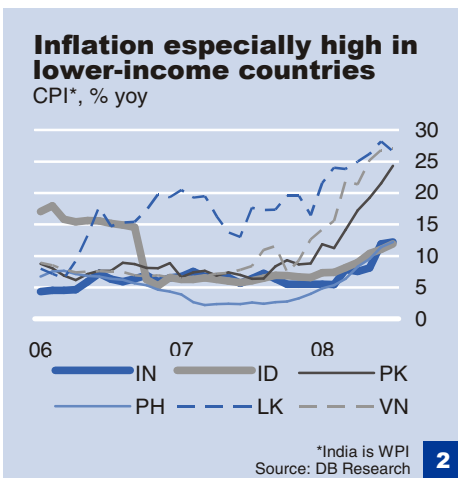
Last year’s trip to Asia was overshadowed by the onset of the subprime crisis. While my first reaction last August was to expect a profound disturbance of the financial sector and a substantial fall-out for the real economy beyond real estate and the construction sector, I certainly would have betted against disruption of the interbank market for as long as 15 months – 2 months was the maximum I considered probable. I correctly stated time and again that subprime was just the trigger of the crisis, but that the real estate sector imbalances – not only in the US – were the deeper causes. I insisted that while banks’ “originate and distribute” model in principle was to be supported – with different regulatory arrangements and better risk managers and rating institutions – excessive reliance on “originate to distribute” was not to be continued. I considered the business model of quite a few investment banks in need of overhaul since certain markets and products were out of fashion with the customer. But, too often, stubborn insistence by some banks on having the right model – that was just not fully understood by the market – stood in the way of reorientation. Thus the financial crisis is still on, with more banks failing, not all write downs being made, bail out consideration plaguing authorities and markets, banking consolidation continuing at sub par speed, and risk premia staying high or even going higher. Liquidity is ample with many investors – not just in many Asian countries with a current account surplus but also with sovereign wealth funds and private households in general. Any asset from real estate, commodities, long-term bonds to equity is considered risky. Risk premia for financial institutions are particularly high. Distrust reigns.

Olympic dreams...

August 2008 was a month of remarkable contrasts. The Beijing Olympics were spectacular from opening to closing. Unbelievable records were achieved. Expected heroes and true surprise stories unfolded before the eyes of billions of spectators. Beijing was beautiful: blue skies, flowers everywhere, an impeccably clean and well-organised city. A bit of charm was lacking, some informal gatherings by the youth of the world might have been missed. But it is obvious: the bar for London, the host of the summer Olympics in 2012, has been raised high.

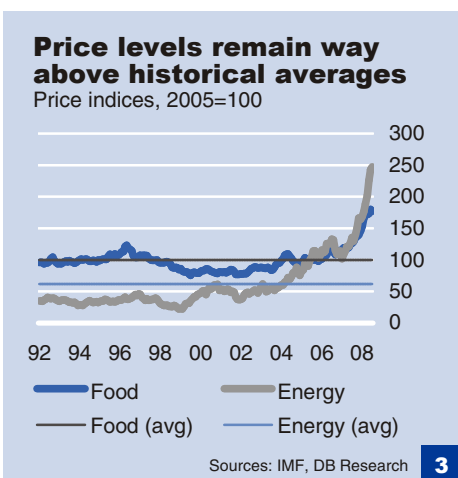


... vs. bank failures, house foreclosures, and Cold War reminiscences



Main Street worries about high food and energy prices

Wall Street welcomes the decline in food and energy prices



Increasing efficiencies needs time

The wonderful festival of sports could not prevent some dark events from unfolding as well, however. Military intervention in Georgia has made the world a colder place again. Confrontation is brewing on a grander scale. The Russian power play will provoke a US/Western/Chinese response. This will not help lower energy prices. It only adds another risk to the globalising world, already suffering from the risk of a failing Doha Round and more opposition against globalisation in populist circles in a number of countries. As if these political tensions were not bad enough, the trouble in financial institutions and the loss of home ownership in many overheated housing markets, especially in the US and Europe, come on top.

Commodity price developments: avoid confusion!

Talking about food and energy prices in Asia this August appeared Kafkaesque. The man on Main Street, the newspaper headlines and politicians were rattled by sky-high food and energy prices. The lifting of price controls and reductions in subsidies were bemoaned. By-election results in Malaysia – Anwar Ibrahim seems to be back in the political arena – coincided with government decisions to reduce only recently increased petrol prices. High food prices – having a particular big weight in the CPI of lower income countries – catapulted inflation into double-digits, with rates of around 25% in countries like Sri Lanka, Vietnam, and Pakistan.

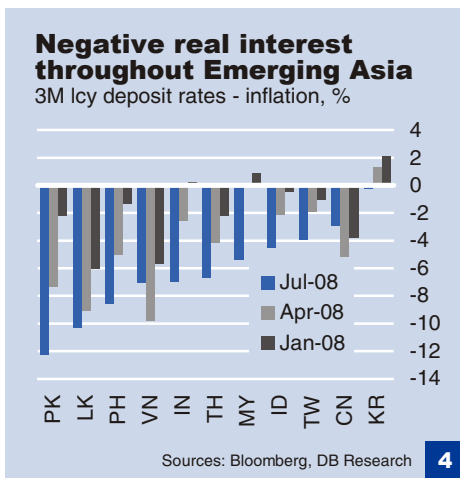
The debate about food and energy prices in financial markets is completely disconnected from the above concerns. On Wall Street, the *level* of prices is neglected, only the *changes* in prices determine the direction of financial variables. Oil prices are down quite a bit, and some other commodity prices are retracing substantially. This has adversely impacted commodity countries. Their currencies have weakened and asset prices, for stocks in particular, have fallen. Inflation expectations do not reflect elevated inflation rates. The US dollar has started rising. The disconnect between Main Street and Wall Street is a source of confusion.

Clarification about price developments in the short and medium term is crucial to help businesses, the financial sector and political authorities to arrive at a meaningful diagnosis and to formulate adequate responses. Formal analysis is necessary but not sufficient. Intuition has to be added. Only if the price corrections of the last few months are viewed from the perspective of a much more dramatic rise in past years and only if higher demand for energy and food due to the ongoing development of emerging markets is taken into account can the course of future events be seen reasonably clearly.

The big inflation problem

It is fair to state that much of today's acceleration of inflation is due to energy and food price increases. In poorer countries where food and energy constitute a bigger share of the CPI basket the effects on headline inflation are particularly pronounced. It is obvious that the root cause of this kind of inflation could be best addressed through higher efficiencies in the use of the scarce resources and an increase of their supply through ambitious investments in the respective areas and their substitutes. But it is equally obvious that efforts in this direction need time to result in substantial supply-side increases or efficiency gains.

Prices are distorted in a number of Asian countries



Some helpful additional changes can be achieved by the immediate effects of higher prices. Unfortunately, some emerging and developing countries have not allowed world market prices of food and energy to feed through to the retail level, thus creating inefficiencies and waste – plus little incentive to build up additional supplies. This is true in a series of the countries that I visited in Asia. Mostly it is political considerations that determine such developments. Narrow majorities and/or approaching elections exacerbate these trends.

But what is to be done about interest rates in circumstances of rather tenacious inflation rates outside target ranges and in double-digits in many Asian countries? The answer varies.

Malaysia believes a central bank rate of 3.5% is right. Inflation, running at almost 10% now, should come back to desired levels in 2009. The credibility of central bank policy is well established, believes the governor. I hope she is right. I dare to voice doubts. Under similar circumstances Bank of Thailand has opted for interest rate hikes, despite criticism from the minister of finance. Politically certainly not unimportant, the King supported the BOT. Long live the King – what a prudent and wise man!

Same divergence in the West not helpful

It is of course not terribly helpful that the same divergence of approaches exists in the West with the Fed hectically reducing rates to more than 3 pp below present inflation and the ECB raising rates even in a downswing. Naturally, the jury is still out on which policy is correct. I consider the actions and communications of the ECB more accurate and solution oriented, because I believe that second round effects are highly probable if and when headline inflation remains so high for so long.

The energy and food bill – two sides of the coin

With so many bets of recent years in financial markets having gone sour, I was often asked for good investment advice. The tongue-in-cheek part of my answer was to suggest marrying an owner of land and/or forests to make best use of the boom for agricultural products and biomass. I was not aggressive enough to suggest marrying an oil-sheik or –oligarch. The elevated levels of energy and food prices, which I expect to prevail despite the present cyclical setback, make for a change of our lives and our life-style.

The riches of the world will change owner

Countries and sectors will witness changes in their terms of trade. Owners of commodities will enjoy a bonanza for ten years or longer. Consumers will pay dearly. Only fast and comprehensive adjustment will help to control costs and develop new opportunities. The knowledge society will strike back – eventually. Rent seekers and asset strippers will enjoy their time for now and a while to come.

Europe and Germany can contribute

Energy efficiency and renewable energy will be rewarding projects, while educating and developing the health sector will pay off. It is particularly encouraging to see how comprehensive an approach China has developed to address these issues. Europe and especially Germany can make a significant contribution to such ventures. To see Germany, for example, being particularly active to help Indonesia to tap its underground ocean of boiling water instead of burning its oil and gas that could be better sold at high prices to the poor guys who do not sit on volcanoes. There are myriads of grand ideas to have proper supply-side responses to the food and energy scarcity and to address the issue of efficiency in both areas.

Exchange rates: Reverse to mean or more weakness for the low interest rate currencies?

As most of the countries around the globe are in a downturn – somewhat less pronounced in Asia's emerging countries – and all are confronted with record high inflation rates and pursuing quite different monetary policies, this may have a confusing exchange rate fall-out. After years of US dollar weakness against most Asian currencies and particularly against the euro, in recent weeks the dollar gained strength against almost all currencies. Some argue it has to do with declining commodity prices. This, however, is the chicken-and-egg issue all over again. Some argue it has to do with reverse to mean. The dollar has weakened too far (30% below its fair value) for too long and thus is now reversing. Others claim the dollar strength is a reflection of the now prevailing belief that Europe and Japan are cyclically declining unexpectedly fast, while the US economy's performance is surprisingly robust. If the latter is the most important factor, the question is whether this relative positioning is a correct diagnosis and/or whether such a relative position can be upheld. I have doubts on both accounts.

Weak dollar is the only stimulus the US can get

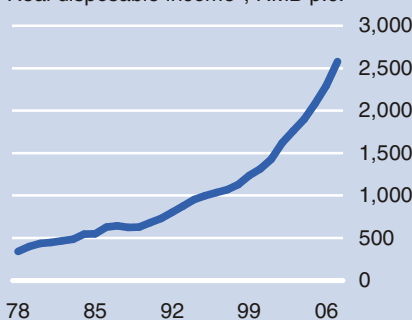
Thus I believe that by Q4 – when the US fiscal stimulus runs out – the correction of the correction for the relative cyclical position will fade, and with it the dollar's strength. Ultimately, a weak dollar is the only stimulus the US can get, as the public deficit makes more fiscal stimulation impossible. Besides, the Fed will not consider interest rate reductions in the face of inflation that is twice as high as nominal interest rates.

Credibility of US institutions at risk

Hopefully stock adjustments out of dollar assets due to calamities at financial institutions and renewed permissive Fed policy in the current decade will not endanger the credibility of US institutions, private and public.

China: Ever richer urban consumers

Real disposable income*, RMB p.c.



*deflated by urban CPI
Sources: CEIC, DB Research

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China – Olympic hangover unavoidable?

In many circles, even some in China, the worry that China will suffer from a hangover after the Olympic party is quite explicit. Yes, there are excess capacities and capacities too fancy and expensive to deliver sustainable returns in Beijing. But this should not be squared with a dramatic growth reduction in China in order to avoid overheating. Chinese exports, especially to the US, are already weaker. But what is not sold to Wal-Mart can be sold to ever richer Chinese consumers who are eager to move ahead. Income development and a high savings rate allow such shifts. Additionally, infrastructure investment, especially in tier 2 and tier 3 cities – preferably in more western parts of China – can and should be increased. Furthermore, incentives to shift away from energy-intensive sectors are being increased. While I do expect a slowdown of growth to 8% in 2009 from the 10% in 2008, I consider this a move towards a lower trend rate rather than an unwarranted cyclical setback. The much debated cyclical stimulus package is an additional insurance against weakening, albeit more symbolic considering the small size of the package which is said to total RMB 200-400 bn (USD 29-58 bn).

Election calendar increases political risks – ethnic/religious strife on the rise

The political situation and outlook are not really reassuring for some countries in Asia. Recent elections have not always brought stability, see Thailand. Political changes in Pakistan have not brought the much-needed stability anchor either.

Improvements visible in some countries

Interestingly enough, quite a few countries challenged by terrorist groups have managed to continue to grow at good rates of some 6%, for instance Pakistan or Sri Lanka.

Other countries considered to be disproportionately prone to ethnic tension have even stabilised lately, like Indonesia, thanks not least to an impressive president. Others like the Philippines are enjoying growth and fiscal rectitude not least because of integration into the global services industry. They are thus benefiting from substantial remittances, which are a backbone of solid external financing of the country's needs.

But others surprise negatively

One – negative – surprise during this trip was India. Not yet truly observable at the surface, a combination of election policies with national Hindu populism in view of the ongoing conflict on Kashmir and the political uncertainties in Pakistan are leading to rising insecurity and to terrorist action that often exhibits brutality not seen in the Middle East (like suicide bombing in hospitals). A Mahatma Gandhi is badly missed. I was astonished to find Indian businessmen addressing such tendencies as risks to the economic development. Hopefully these events will remain rare and limited in their political and economic consequences.

Another negative surprise was Malaysia. The increased adoption of Sharia law and the erosion of the UMNO movement are challenges to governance in a country which enjoyed strong government effectiveness and good regulatory quality – not unlike Singapore's - for so long.

Global downturn and impact on Asia – a mixed bag

As in the US and in Europe, the cyclical profile in some countries in Asia is difficult to read. Seasonal adjustments in Japan seem to have similar defects as in Europe: neither was Q1 a boom quarter nor Q2 a recession. Probably the Q2 reductions of GDP in Hong Kong and Singapore should be taken with a grain of salt.

But it is quite obvious that some countries in Asia with extremely high exports to the US should be affected by the downturn. In general, more open countries should be considered more dependent, thus vulnerable. There is little one can or should do to change this – ultimately, the openness of the city-states is the backbone of their success. Households and companies should have reserves to weather such fluctuations, rather than to aspire to autarky.

Nonetheless, the giant Asian countries are less affected and additionally have room for domestic countermeasures. Other Asian countries which are exporters of commodities should benefit from the improvement in their terms of trade, thus avoiding a downturn altogether. Asia at large should post almost unchanged growth in 2008 compared to 2007. In 2009, a reduction of average growth of up to 2 pp is my guess today, partly a result of the global downturn, and partly a result of more restrictive policies to rein in inflation.

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Asia

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China and India are for good reasons in the spotlight as these two rising economic powers hold the promise of becoming the two biggest consumer markets in the world. Likewise, in both countries economic reforms and financial market development have been accelerating opening up a multitude of new investment opportunities. But Asia is more than China and India. A decade after the Asian crisis many investors are rediscovering the potential of the economic tigers of East and Southeast Asia as attractive destinations for business, trade and investment. The region's diversity creates synergies and opportunities which are yet to be fully realised and newcomers from South Asia or Indochina are introducing further business possibilities. Therefore, this research series provides readers not only with studies, presentations and commentaries on economic and structural issues in China and India, but also takes a look at the prospects and policy challenges of other Asian countries as well.

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