# Manu Bhaskaran: How will the global economy affect Asia in 2010?

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AS THE GLOBAL economy recovers from the worst downturn in decades, the concurrent economic indicators are turning up and forecasters everywhere are upgrading their estimates for economic growth next year. For businesses and financial investors, however, the key is not the 2010 GDP growth number: Barring another disaster, 2010 GDP growth on average has to be much higher than the disastrous performance in 2009. What really matters for business operations and financial-market behaviour are the forces that underlie this average growth for the year.

**Policy support remains essential but could be problematic**

First, economic activity still depends substantially on government policy support, not just in the crisis-hit developed economies such as the US and Europe, but also in the emerging economies of Asia. In the developed economies, the necessary adjustments to overcome the causes of the crisis — deleveraging by consumers and financial institutions, operational restructuring by businesses to adjust to lower growth and currency changes including reducing headcounts, substantial regulatory changes — will continue to exert a drag on economic activity. Since these economies remain the largest markets for Asian exporters and since it will be a while before China and other large developing economies can replace these developed markets, Asian economies will also need policy support to maintain reasonably good economic growth rates. Remember that consumer spending in the US and European Union, about US$20 trillion ($27.7 trillion), is 10 times that of Chinese consumer spending.

But there are difficulties with fiscal and monetary stimulus packages:

- First, it is not clear how quickly they affect domestic demand and how prolonged their effects are — we could get some months where the impact of these policies is very pronounced, giving way to months when demand falls sharply. This is clearly seen in the impact of special fiscal incentives to buy cars ("cash for clunkers") and first-time home buyers' credit — as soon as these were withdrawn, demand in these respective areas fell precipitously. In much of the world, the bulk of the fiscal stimulus impact will be over by the middle of next year, with fiscal policy actually turning contractionary before year-end; and
- Second, there are growing concerns about the sustainability of monetary and fiscal stimulus. China is not the only one complaining about lax US monetary policies: Inflationary expectations in the US have risen and there is growing pressure on the US Federal Reserve to explain its strategy to exit from the unprecedented easing of monetary policy since September last year. The huge rises in public debt are beginning to worry bond markets and are also creating a political backlash from more conservative voters who are alarmed by the long-term consequences of high public debt.

This places a constraint on how easily governments in the US and Europe can add further stimulus — they may not even be allowed to do enough to prevent fiscal policy from turning contractionary by end-2010.

**Unresolved financial problems**

In addition, as shown by Dubai's debt woes, there remain unresolved financial problems in the global economy that can come back to haunt us. In particular, investors should watch out for:

- ***Emerging market stresses.*** The crisis affecting debt owed by Dubai's companies has focused attention on other areas where excessive borrowing could create problems. In Europe, Greece is seen as risky because its fiscal deficit has turned out to be a lot higher than the government had initially indicated and many now fear that its public debt position is already unsustainable. Since Greece is a member of the eurozone, it does not have the option of devaluing its way out of the crisis, which means that its adjustment will be painful and will create political difficulties that may affect confidence in the euro. Other European economies such as Latvia also remain perilously close to the brink of financial crisis; and
- ***Commercial property loans in the US and the UK.*** The default rate on US commercial real-estate loans doubled in 3Q2009 to 3.4%: With vacancies rising and rental rates falling, defaults will rise significantly, posing a major risk to the regional banks that are the main lenders in this category. The number of bank failures in the US will almost certainly continue to rise.

**Exchange-rate shifts**
There are several important turning points in global currencies. The main issue is the US dollar: Aside from short-term technical moves that might see the oversold US dollar shoot up temporarily, the longer-term outlook is for its further decline. This US dollar depreciation is needed to support the US economy's restructuring to reduce its persistent trade deficits. So far, the burden of its depreciation has been borne by the euro and commodity-related currencies such as the Canadian and Australian dollars. This cannot go on. The pressure on China to revalue its currency will rise sharply. It is not only the US and Europe that are getting tough with China — many developing economies feel that China's insistence on linking its renminbi (RMB) to the depreciating US dollar is hurting them. However much the Chinese may complain that it is unfair to blame China, the reality is that pressure will grow on China. It will have little choice but to change its currency policy next year.

**Implications for Asia**
In other words, while Asian economies will probably enjoy a stronger year in 2010, it will still be a rough ride, with many challenges.

First, higher economic growth in 2010 will mask huge volatility. External demand will fluctuate unpredictably — one quarter might see substantial strength and the next, the reverse. Policymakers and businesses will need to manage this volatility.

Second, the implications for capital flows into Asia will be critical. The global economy has yet to come to grips with the damaging way liquidity is generated in the global economy, producing frequent bouts of speculative capital flows into emerging markets that are often destabilising. So long as the US, Europe and Japan see it in their interests to keep rates low, substantial amounts of capital will seek higher returns in emerging markets next year. As emerging markets recover ahead of developed economies, risk appetites of large investors will improve and we will see massive flows of speculative funds into countries as diverse as China, Indonesia, Vietnam and Malaysia. Emerging Asian economies will struggle to cope with the consequences of such flows for their currencies, domestic liquidity management and asset bubbles.

Third, if we are right that China will have no choice but to change its currency policy, there will be major consequences for other Asian economies. We think that China will probably return to its policy in 2005 to 2008 of a gradual appreciation against the US dollar. That will give room for other Asian currencies to appreciate as well. Businesses will need to factor in stronger currencies.

Fourth, the world economy is recovering but the risks described above imply that Asian economies will still face many shocks in the coming year. It is vital that businesses and policymakers direct their energies to building resilience to such shocks. The lessons of the past year show that countries that got their basics right — those that husbanded their fiscal resources carefully; avoided excessive leverage in the balance sheets of their banks, companies and households; allowed their central banks to be credible inflation-fighters; and diversified their economies and revenue streams — did better. Asian policymakers should further improve these areas to build resilience against the inevitable shocks that will come from a still-troubled global economy.

In short, the recovery next year will be welcome in Asia but it will not mean a respite from challenges.

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