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Asia – outlook after the crisis

Allianz

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1. THE GLOBAL ECONOMIC FRAMEWORK – AN OVERVIEW

Thanks not least to the unprecedentedly expansive economic policy implemented across the globe, the world economy was able to shake off the recession in early 2009 and increasingly got back into stride as last year progressed. Although the exceptionally severe winter put something of a temporary damper on economic activity in many countries in the first three months of 2010, leading indicators and business surveys suggest that the underlying economic momentum is headed clearly in the right direction, and point towards a good chance of sustained growth. Encouragingly, the rise in overall output has now also helped to ease labor market tensions somewhat. The global economy is set to grow by 3.4% in 2010 and by 3.2% in 2011 (compared with -2.1% in 2009).

The economic recovery process has, however, varied considerably from region to region and from country to country. Among the industrial countries the USA has been able to take a lead. The emerging economies of the Asian continent are playing a key role in the revival, with China the driving force.

When assessing developments in 2009, which turned out far better than the media, policymakers and business had expected, the following aspects played a role:

- protectionism on a major scale was avoided
- the emerging markets, particularly in Asia, were able to regain rapid economic momentum swiftly
- no lasting renunciation of market economy principles took place and there is no evidence of an overregulation of the financial markets.

The other side of the coin is the considerable economic policy challenge that now awaits due to the state of government finances. The cyclical impetus imparted by the economic stimulus packages will gradually peter out, and by 2011 at the latest, fiscal policy will be a drag on economic activity.

Major risks that could stand in the way of the global economic recovery are:

- an escalation of the sovereign debt crisis
- the formation of asset price bubbles and commodity price rises, such as a new oil price spike
- marked exchange rate fluctuations
- inflation if very expansionary monetary policy is abandoned too late

2. REGIONAL ECONOMIC OUTLOOK

Asia's emerging markets have weathered the most severe global financial and economic crisis witnessed since the Second World War far better than one would have imagined only just over a year ago. And that's not all: Asia was also the first region in the world to experience a considerable recovery in economic activity last year. So it is by no means an exaggeration to say that Asia played a key role in steering the global economy out of the toughest recession in decades. It does actually come as something of a surprise that, of

all regions, Asia, – renowned as it is for its heavy reliance on exports – was the first to clamber its way out of recession, while at the same time those countries that happen to be Asia's main export markets had literally collapsed. There are two main reasons behind this phenomenon:

- First, Asia's financial institutions held hardly any investments in problem loans and bonds, unlike their US and European counterparts. This means that the local financial systems in Asia were able to continue functioning normally and providing the economy with loans, even during the worst phase of the financial crisis in the six months spanning the winter of 2008/2009.

- Second, the rapid and very dynamic recovery witnessed in Asia's emerging economies owes itself to the very fast and aggressive action taken on the monetary and fiscal policy front. A long period of very stability-oriented fiscal policy, at least in most countries, gave many governments considerable room for maneuver, allowing them to both develop and then implement extensive economic stimulus packages within a very short space of time.

Obviously, Asia's emerging markets did not experience identical economic development last year. This varied, sometimes considerably, from country to country, for example as far as the extent of the economic slump or the momentum of the subsequent economic recovery are concerned. A glance at the average annual growth rates for 2009 shows that countries with a large domestic market showed relatively solid performance all in all, whereas smaller economies that are heavily reliant on exports were hit particularly hard by the collapse in world trade, resulting in a drop in economic output. Despite the crisis, the Indonesian economy, for example, returned real growth of 4.5% in 2009, whereas Malaysia's GDP contracted by 1.7%. By way of comparison: Indonesia's exports recently accounted for just under 43% of GDP, while Malaysian exports stood at more than 108% of the country's GDP.

Growth rates in Emerging Asia

- real GDP, percentage change over previous year -

	2007	2008	2009	2010[1)]	2011[1)]
China	13.0	9.0	8.7	10.0	9.0
India	9.0	6.7	6.8	7.5	7.5
Indonesia	6.3	6.1	4.5	5.5	4.7
Malaysia	6.2	4.6	-1.7	5.5	4.5
Singapore	8.2	1.4	-2.0	7.5	4.5
South Korea	5.1	2.2	0.3	5.0	4.5
Thailand	4.9	2.5	-2.3	4.0	4.0
Emerging Asia	**10.4**	**6.8**	**5.5**	**8.1**	**7.3**

1) forecast.

As 2009 advanced, the economic recovery gradually permeated the entire region. The economic data for Q4 2009 are clear testimony to the fact that Asia's emerging markets closed the crisis year of 2009 with considerable economic momentum. What is more, the economic indicators that are already available for the first quarter of 2010 (including GDP data for China, Singapore and South Korea) suggest that Asia's emerging markets have carried this momentum with them into the new year as well. All in all, the overall conditions for a continuation of the brisk economic development seen of late are looking good: the recovery in world trade is plowing ahead. Inventory levels in the industrial sector had been slashed appreciably. Given the positive economic sentiment, moves are likely to be made to begin increasing inventory levels again, which holds the promise of

additional growth impetus. Last but not least, the various fiscal stimulus packages, which will run until the end of 2010 in the majority of countries, will provide a boost for domestic demand this year. All in all, we expect to see real economic growth of 8.1% for the entire region in 2010. Next year, the increase, at 7.3%, is likely to be less pronounced, mainly because the stimulus packages will have run their course by then.

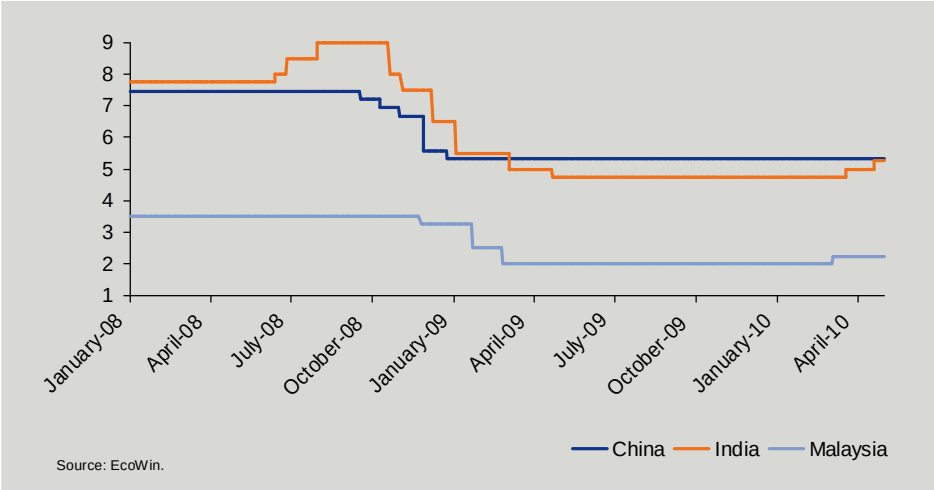
In economic policy terms, the challenges facing Asia this year are barely less demanding than they were last year. In 2009, economic policy focused on limiting the negative impact of the global financial and economic crisis on individual Asian economies. In 2010 and 2011, the challenge now facing these countries will be to adapt economic policy to reflect the new (global) environment. For one thing, this will involve gradually curtailing state stimulus and support measures. For another, however, economic structures will have to be realigned to a certain extent. With global imbalances now declining, the Asian emerging economies will have to focus more on domestic, and less on export demand if they want to continue to achieve strong growth in the future. The economic policy challenges facing these countries will place demands not only on monetary and fiscal policy, but also on exchange rate policy (regarding the role played by exchange rate policy, see Chapter 3 "The importance of more flexible exchange rates").

Once the fiscal stimulus packages have run their term at the end of 2010, the Asian economies should return to the sustainable fiscal policy most of them were pursuing in the years before the financial and economic crisis. After all, it was precisely this fiscal discipline that allowed these governments to find fast and emphatic answers in the face of the economic slump, and then to counteract the crisis by increasing government demand accordingly. Despite the calls for a return to fiscal discipline, the political powers-that-be have various options open to them when it comes to helping to adjust the economy to reflect the new environment. One example would be the option of strengthening the economy's automatic stabilizers: better protection in the event of unemployment could help to stabilize economic development and make a contribution to improved social security structures without jeopardizing the sustainability of public finances.

While, as described above, it is likely to be next year before the economic stimulus provided by fiscal policy dwindles appreciably, the past few months have already seen various central banks in the region take initial steps to gradually get their monetary policy back to normal. The Indian and Malaysian central banks, for example, both lifted their key interest rate by 25 basis points in March. India went on to implement another interest rate hike in April. In the same month, the Monetary Authority of Singapore revalued the Singapore dollar by 1¼% against the US dollar, and also announced that it would be allowing gradual further appreciation in the future. This is nothing other than a move to tighten the monetary policy reins. Furthermore, China has already lifted its minimum reserve ratio three times since January. We expect the Chinese central bank to implement further measures, such as lifting the key rate, over the coming months. Most other Asian countries are also expected to shift the focus of their monetary policy as the year progresses, with less emphasis on boosting growth and more on keeping inflation in check.

First rate hikes by Asian central banks

Key interest rates, in percent



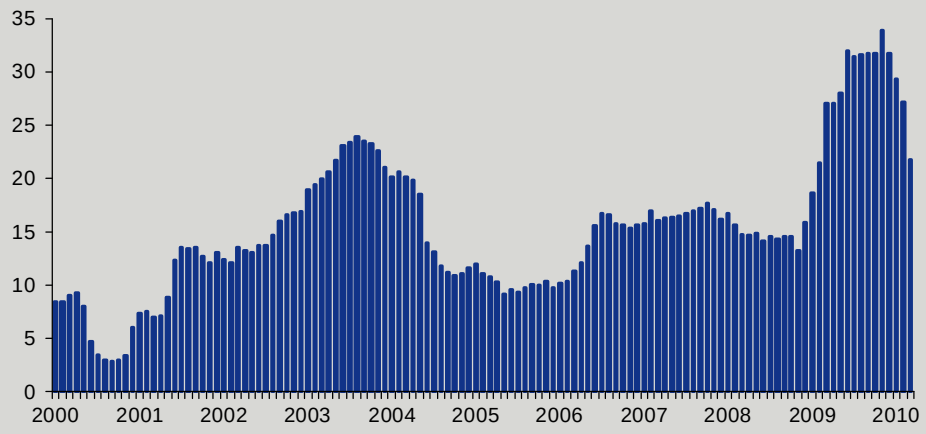
China: Economic boom fuels overheating fears

The economic stimulus package unveiled by the Chinese government in the fall of 2008 resulted in a considerable revival in economic activity last year. Not least thanks to the decision to structure the program as a two-year plan, the recovery has continued this year, too. In the first quarter of 2009 Chinese economic growth stood at only 6.2% year-on-year in real terms. Growth rates have been on a continued climb ever since. China's economy grew by 11.9% in the first three months of 2010, the sort of growth last seen in the fourth quarter of 2007. This hefty increase is, however, likely to have been favored, at least in part, by the weak growth witnessed in the same quarter of last year. Current economic indicators suggest that this very buoyant growth is set to continue. The official purchasing managers' index, for example, recently climbed to 55.7 points, well above the 50-point expansion threshold. China's corporate sector is particularly optimistic as far as the order books are concerned, with the corresponding sub-index recently surpassing the 59-point mark.

All in all, the risks of China's economy overheating have been mounting in recent months. Although credit growth has slowed considerably of late, the new loans granted in the first quarter of 2010 already accounted for more than a third of the government's total annual target volume of CNY 7,500bn. Back in 2009, the banks had opened their lending floodgates wide to help stimulate the domestic economy, granting new loans worth a total of around CNY 9,600bn. By way of comparison, the average new lending volume in the period between 2000 and 2009 came in at somewhere in the region of CNY 3,000bn a year. The sort of lending expansion that we saw last year can only mean one thing: laxer checks on credit-standing. Consequently, non-performing loans are expected to start increasing in the near future. This is also likely to be one of the reasons why, several times in recent months, the Chinese banking supervisory authority has urged the country´s financial institutions to reinforce their equity base.

China: Banks slam on the lending brakes

Loans by monetary financial institutions, % change over previous year



Source: The People´s Bank of China (EcoWin).

The development of real estate prices in China's cities is also cause for concern. In March 2010, they were up by almost 12% on the previous year, with a year-on-year difference of as much as more than 50% in some cities, like Haikou and Sanya in Hainan province. While the situation does not equate with a nationwide property bubble, it definitely does as far as the country's major cities are concerned. A burst bubble would certainly leave its mark on the economy. After all, around 20% of investments, the very force behind the current upswing, are destined for the residential construction sector. What is more, a potential loss of wealth would be bound to hit consumer demand as well. All in all, however, the bursting of the real estate bubble would have a far less harrowing impact on the Chinese economy than it did in the US in 2008 and 2009: according to figures released by the Chinese central bank, only a little over 12% of all medium and long-term loans granted last year were attributable to the real estate sector. Furthermore, even when the economy was at its absolute low point last year, Chinese banks were demanding that private households looking to buy real estate put down equity of at least 20%. This means that the leverage is far lower than for US households. Last but not least, the Chinese financial system is also far less developed than in the industrialized countries. This means that exotic, intransparent financial products that proved to be a real burden in the most recent crisis, do not exist. The government is aware of the risks associated with the real estate market, and announced a further package of measures aimed at stemming the property boom in mid-April. The percentage of equity required from individuals looking to buy a second home, for example, has been pushed up once again, from 40% to 50%. Furthermore, the interest rate charged on loans for second properties will be at least 110 basis points above the reference rate in the future. These measures are clearly aimed at curbing speculation on the real estate market. If they fail to have the desired effect, additional measures are likely to follow over the next few months, and could even include the introduction of a tax on property assets.

So the big challenge facing China's economic policy this year will be to abandon an extremely stimulative economic policy without choking the economy in the process. We expect the central bank to continue to tighten its monetary stance in the coming months. Given that it has only lifted the minimum reserve ratio for banks so far, it is likely to start gradually putting its key rate up in the near future. This, combined with further lending restrictions, is expected to result, among other things, in a less pronounced increase in new loans.

We also expect China to loosen its exchange rate policy over the next few months. We estimate that the renminbi will gradually appreciate against the US dollar from the second half of the year at the latest, meaning that by the end of the year it should be worth around 2 to 5% more than at the close of 2009. We will go into further detail on the reasons behind this assumption in Chapter 3. All in all, the gradual withdrawal of economic policy stimulus is likely to slow economic momentum in the course of the year. We estimate that China will achieve real economic growth of 10% for 2010 as a whole, and 9% next year.

India: A firm grip on the crisis

Strictly speaking, India had to juggle two major challenges last year: the global financial and economic crisis on the one hand, and severe crop failure caused by the most subdued monsoon rain seen since the early 1970s. The Indian government launched several economic stimulus packages to ward off the impact of the crisis. And they worked: in the course of the fiscal year that came to a close at the end of March 2010, India witnessed a considerable economic recovery, thanks primarily to robust consumer demand among private households and the state alike. Fiscal policy was backed up by a very expansionary monetary policy: in the course of the crisis, the country's central bank implemented a drastic cut in the key rate in several stages, bringing it down from 9% to 4.75%, the lowest level since the fall of 2004.

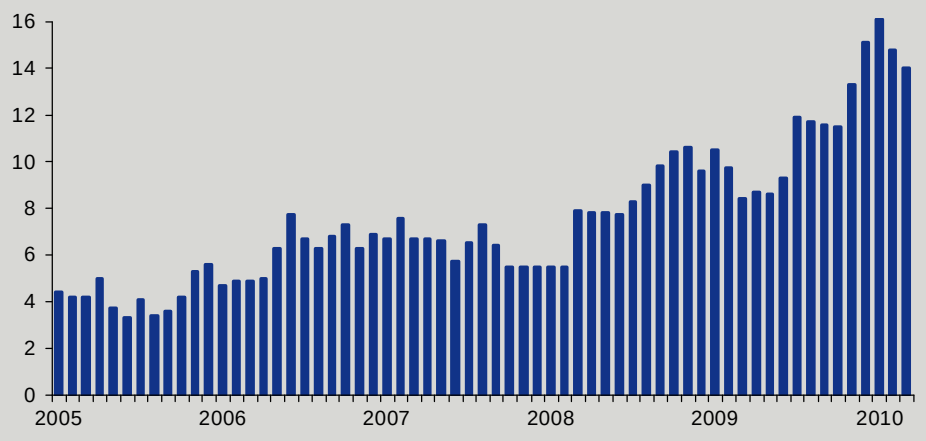
Current economic indicators, such as sentiment surveys in the industrial sector, suggest that the recovery is ongoing. The government also expects to see stable economic development and has already started to gradually withdraw the stimulus that has been pumped into the economy as a result of the crisis. One of these moves involved at least partly reversing the temporary reduction in value added tax by four percentage points. Monetary policy has also started moving towards normalization: after the central bank started lifting the minimum reserve ratio for banks in February 2010, they implemented the first key rate hikes of 25 basis points each in March and April, putting the current key rate at 5.25%. Further steps are expected to follow as the year moves on. We predict that the key rate will stand at 6% by the end of 2010. The Indian economy is likely to grow by around 7.5% in real terms both this year and next. This forecast is a good 1½ percentage points below the growth rates witnessed in the years before the crisis, and also takes account of the fact that the imminent budget consolidation program will put something of a damper on growth.

With economic development now looking robust, it makes sense to gradually wean the economy off the extra stimulus. The state of government finances also argues for an exit. In fiscal 2009, the central government's budget deficit stood at 6.7% of the country's gross domestic product. If we also take into account the budgets of the federal states, the consolidated state deficit is even likely to have topped the 10% mark. There is no doubt that the fiscal policymakers had to step in to counter the demand slump triggered by the crisis. But the fact that government debt is already high, and is estimated to have stood at around 82% of gross domestic product last year, makes convincing consolidation all the more crucial. The government aims to achieve a deficit of 5.5% this year, and 4% next year. Around half of this year's consolidation, which corresponds to 1.2 percentage points of GDP, will come from the revenue side. The main elements involve higher tax revenues thanks to stronger growth and a return to higher VAT rates, as well as proceeds from privatizations. On the expenditure side, the government plans to cut subsidies for fuel and fertilizers, for example.

Last but not least, the substantial increase in consumer prices since the middle of last year suggests that it is time to tighten the monetary policy reins. In January 2010, inflation stood at 16.1% compared with the previous year, the steepest rise since November 1998. In February and March, the inflation rate then dipped slightly to 14.8% and 14% respectively. Much of the surge in inflation is doubtless attributable to a considerable extent to last year's crop failure, meaning that it is not a permanent feature. Inflationary pressure for food is expected to ease considerably after the winter harvest in Q2 2010 at the latest. On the other hand, the price of fuel, for example, is likely to rise in reaction to the planned subsidy cuts. All in all, the increase in consumer prices will slow in the course of the year. They are expected to rise by an average of 10% this year compared with 10.9% last year. Looking ahead to 2011, we then expect inflation to subside further to around 7%.

India: Bad harvest leads to a strong increase in inflation rates

Consumer prices (industrial workers),% change over previous year



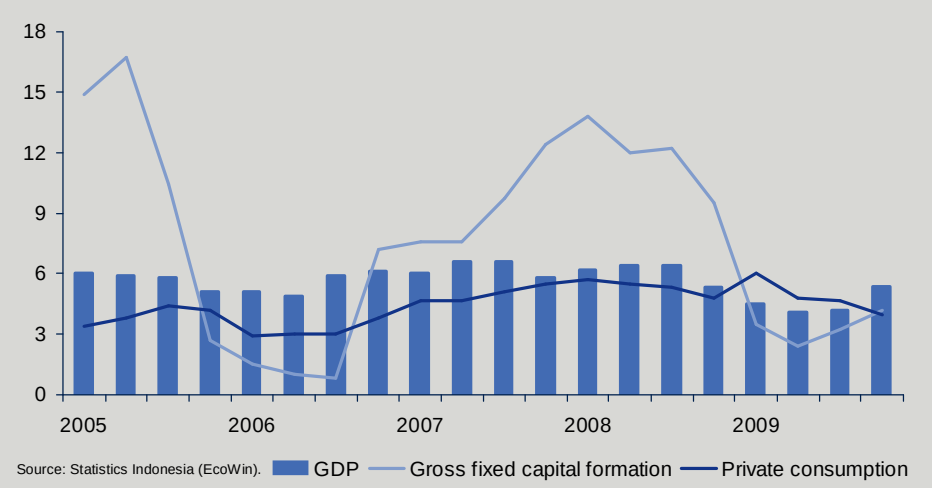
Source: Labour Bureau, Government of India (EcoWin).

South-East Asia: Recovery momentum linked to export reliance

The governments and central banks of South-East Asia also reacted to the global downturn by launching fiscal economic stimulus packages and loosening their monetary policy stance. Of the larger countries in the region, Indonesia was by far the most successful at coping with the financial and economic crisis. In addition to the country's expansive economic policy, the largest ASEAN country owes this success first and foremost to its relatively low dependence on exports, as well as to its large and robust domestic market. In spite of the crisis, private consumption rose by just short of 5% in real terms last year, meaning that it accounted for far more than half of economic growth. At 4.5%, real GDP growth was down by only just over 1 percentage point on the previous five years. In addition to private consumption, investments are likely to provide considerable growth impetus this year. We believe that investment activity will benefit in particular from improved loan availability, various tax incentives and the fact that the industrial sector will have to step up not only its replacement but also its expansion investments in view of the solid economic growth witnessed over the past few years. All in all, the Indonesian economy is likely to grow by around 5.5% in real terms this year. We expect to see growth of 4.7% next year.

Indonesia: Private consumption acts as a stabilizer

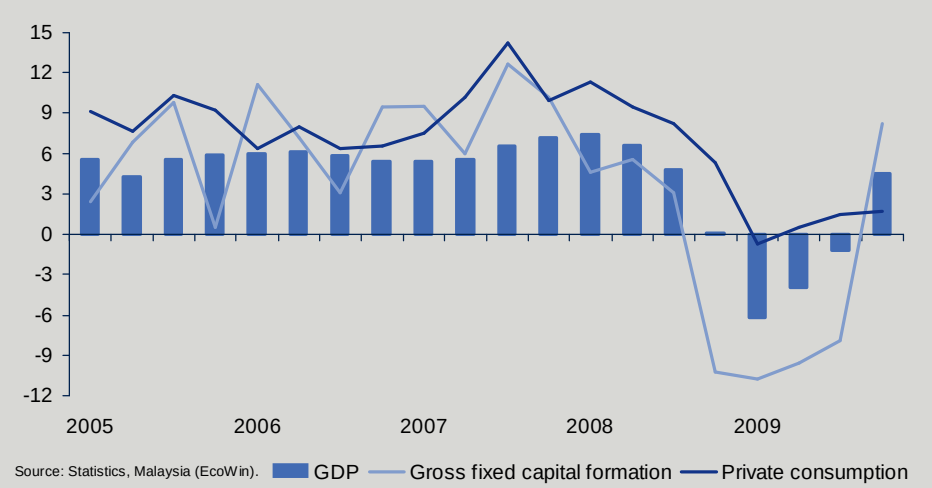
GDP components, % change over previous year



Malaysia, alongside Singapore and Thailand, is on the list of countries that were hit very hard by the global recession. The reason behind this development is evident: all of these countries are small, open economies whose resulting reliance on exports left them susceptible to a mighty tumble when world trade collapsed. Malaysia's export volume fell by a good 10% in 2009. Investment decisions were either postponed or abandoned completely, resulting in a 5.5% dip in investments. Malaysia reached its economic low point in the first three months of 2009, when real GDP was down by 6.2% in a year-on-year comparison. Economic development has been going from strength to strength ever since, thanks primarily to the fiscal stimulus package and the revival in world trade. The latter also looks set to be the driving force behind economic development this year. Just as the country's heavy reliance on exports explained the severe economic slump last year, it is now the reason behind the rapid recovery. After economic output fell by 1.7% in real terms in 2009, the economy is expected to return growth of 5.5% in 2010. Growth is then expected to slow to 4.5% in 2011, not least due to the withdrawal of the fiscal stimulus.

Malaysia: Investment collapses in the wake of the crisis

GDP components, % change over previous year



Asian bond markets once again saw buoyant growth last year. According to the Asian Development Bank (ADB) in the March 2010 issue of its "Asia Bond Monitor", the volume of outstanding bonds in local currency in 2009 rose by 16.5% on the previous year. Corporate bonds put in a particularly dynamic performance, with the volume rising by 31%. Of course, by international standards, the local bond markets in Asia are still relatively small. Taking the average of all countries, their size equates to only just over half of economic output in the region as a whole. By comparison, the figure in Germany is more than 130%. But one thing is certain – the local bond markets will continue to gradually gain in importance, not least for foreign investors. In the following, we put the spotlight briefly on two local bond markets.

The Indonesian bond market recorded above-average growth of 19.4% in 2009. However, the starting point here is particularly low: at the end of 2009 the overall volume of the local Indonesian bond market corresponded to a mere 19% of gross domestic product. The central government and the central bank are by far the largest actors, accounting together for just under 91% of the overall outstanding volume. Corporate bonds have picked up significantly of late, but their share is still very low at around 9%. After the banks (with a share of 44%), foreign investors are the second largest investor group in Indonesian government bonds in local currency. Their share crept up slightly to 19% by September 2009 from 17% a year earlier. Although "only" two percentage points, this increase reflects not least growing interest among international investors for the country and its positive economic performance in recent years.

Developments on the Malaysian bond market are also interesting. The overall volume rose by only 10.3% in 2009, below the average. But in terms of its share in gross domestic product of 96%, it has been one of the largest in the region for a while now. Corporates play an important role on the Malaysian bond market. Most recently their bonds accounted for a good 45% of the total outstanding volume. This compares with a regional average of only 29.5% for the corporate sector. The "Islamic bond market" was once again the main driver behind the 9.6% growth in corporate bonds last year. While the overall volume of traditional corporate bonds fluctuated over the past decade between Ringgit 90bn and 119bn, the volume on the "Islamic bond market" rose significantly year for year from just Ringgit 39.5bn in 2001 to Ringgit 169.8bn last year. In Malaysia, too, foreign investors are the second largest investor group in government bonds after the banks. At the end of September 2009 their share stood at 12%, up from only 10% at the end of 2008.

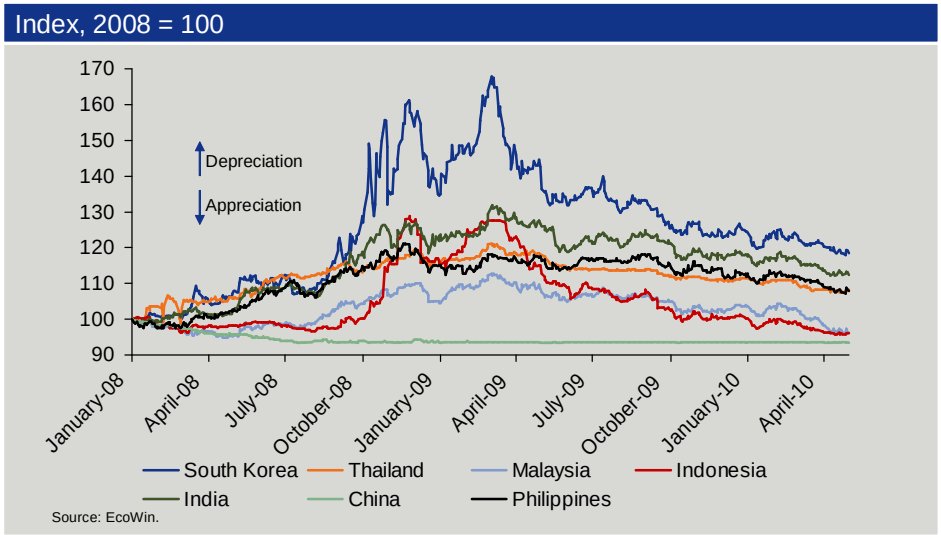
3. THE IMPORTANCE OF MORE FLEXIBLE EXCHANGE RATES

In the aftermath of the Asian crisis of 1997 and 1998, most of the countries affected by the crisis opted to make their exchange rate systems more flexible. In de jure terms, they switched from more or less rigid fixed rate systems to flexible exchange rate systems, although the degree of flexibility varied considerably from country to country. South Korea, for example, introduced a regime of freely fluctuating exchange rates, whereas Thailand opted for a managed flexible exchange rate. Malaysia was the only country to choose a strict fixed rate system again after the crisis, before finally easing its exchange rate policy in 2005. China, which was not affected directly by the Asian crisis, kept the exchange rate between the renminbi and the US dollar fixed from 1999 onwards, before transitioning to a managed flexible exchange rate system based on a currency basket in mid-2005. Three years later, in the summer of 2008, China put the brakes on the gradual appreciation of the renminbi against the US dollar and has once again been keeping the exchange rate constant ever since.

Discrepancy between exchange rate systems in theory and practice

In its most recent "Asian Development Outlook" published in April 2010, the Asian Development Bank (ADB) stated that, while many countries made their exchange rate regimes more flexible in de jure terms following the Asian crisis, this has done nothing to change the fact that the exchange rate fluctuations between the individual currencies and both the US dollar and trade-weighted currency baskets are still fairly minor. This understandably raises doubts as to the extent to which the official theory behind the exchange rate systems corresponds to what is actually put into practice. Compared with currencies in countries like Australia and Japan, exchange rates in Asia are far less volatile. This can be explained by the considerable interventions made by Asia's emerging markets in the currency markets. To cite one example: in the wake of the Asian crisis, the volatility of the Thai baht was more or less comparable to that of the Philippine peso. The International Monetary Fund (IMF) does, in fact, classify the Philippine exchange rate system as "independently floating", whereas it describes Thailand's as "managed floating". So one would expect that the exchange rate performance of the peso would be subject to far more fluctuation than that of the baht.

Development of Asian currencies vis-à-vis the US dollar



The extent of the exchange rate management that takes place is particularly evident if we look at how currency reserves have developed. According to figures released by the IMF, there has been a huge increase in the currency reserves of all of Asia's emerging markets over the past seven years, bringing them up by USD 2,501bn to total USD 2,998bn at the end of last year. By way of comparison, the cumulative current account surplus totaled USD 1,792bn during the same period. What are the fundamental arguments in favor of a country intervening on the currency market and accumulating currency reserves? On the basis of empirical literature, the ADB points to three key aspects in its most recent report which we would like to briefly address here:

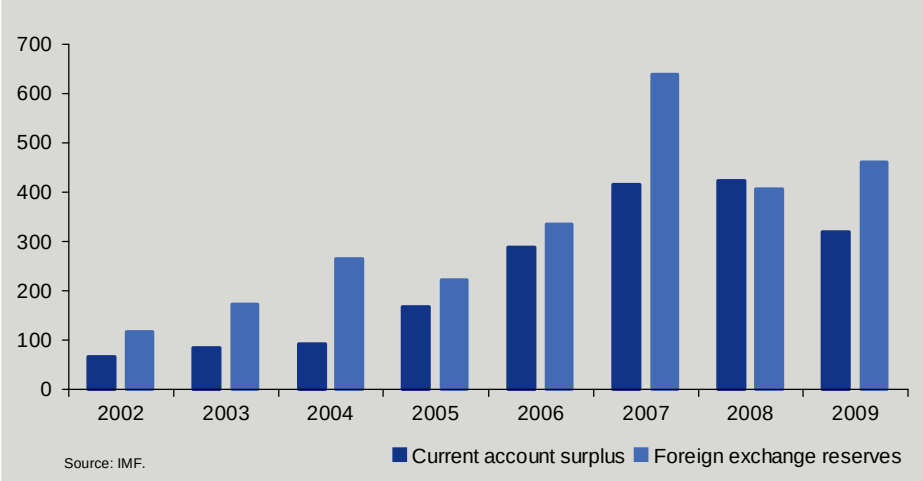
1. Insurance: countries build up foreign currency reserves to give them a safety net to fall back on in the event of a crisis. There is no doubt that the currency reserves have proven very helpful in keeping the negative impact of the most recent crisis on the individual economies within bounds. This is particularly the case as far as stabilizing exchange rates after sometimes hefty depreciation is concerned (example: South Korean won). Of course, the question as to what a reasonable level for a country's currency reserves should actually be remains open in principle.

2. Boosting exports: during normal periods, central banks often intervene on the currency market to boost exports, and therefore ultimately growth. Studies performed by the ADB show asymmetric intervention in the case of most Asian emerging markets, with a strong tendency towards avoiding appreciation rather than depreciation.

3. Exchange rate fluctuations: one of the reasons why considerable exchange rate fluctuations are problematic is because they deny economic players the security that they need to plan ahead. Exchange rate fluctuations are particularly problematic if they are triggered not by fundamental issues, but by speculation. This results in a situation in which price signals are distorted and the exchange rate moves away from its equilibrium level, which can ultimately destabilize the economy.

Exchange market intervention speeds up rise in forex reserves

Rise in forex reserves & current account surplus of Emerging Asia, in USD bn



Source: IMF.

Advantages of greater exchange rate flexibility

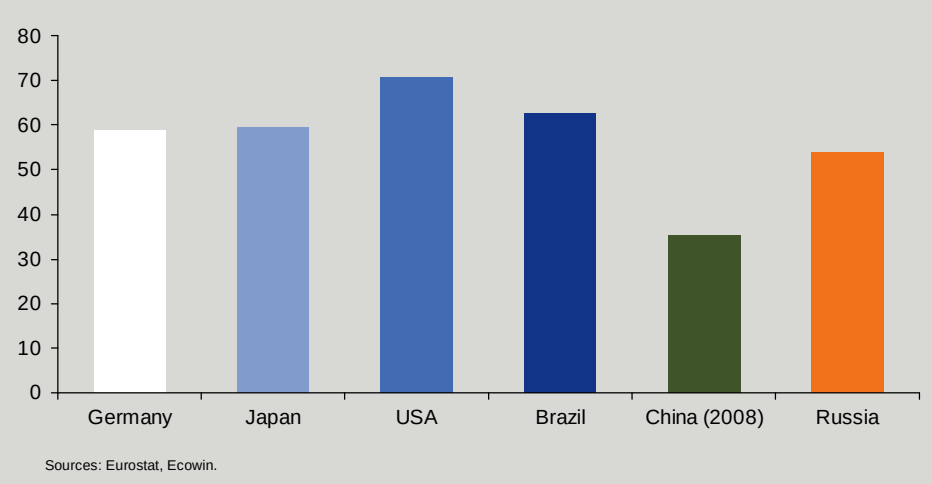
In the past, numerous studies have addressed the issue of how to determine equilibrium exchange rates. The issue has recently been pushed into the limelight again, especially given the current debate on Asia's exchange rate regimes and global imbalances. In their most recent analysis published in January 2010, economists Cline and Williamson from the Peterson Institute of International Economics estimated the equilibrium exchange rates for numerous currencies around the world. Based on the exchange rates as at the end of 2009, they conclude that the exchange rates of a whole number of Asian currencies against the US dollar are often far removed from the level that is justified from a fundamental perspective. If we look at exchange rates not against the US dollar, but against a trade-weighted currency basket, the number of cases of significant undervaluation is reduced to four currencies, the Chinese renminbi, the Malaysian ringgit, the Singapore dollar and the Taiwan dollar. The extent of undervaluation ranges from 10% to 21%, depending on the currency. Although some other studies produce different results on the range of undervaluation, there is broad consensus that many Asian currencies are significantly undervalued at present.

Even though it might be politically controversial, in our analysis we are assuming a further flexibilization and therefore appreciation of the Asian currencies. For the countries concerned, this could indeed bring advantages for the domestic economy.

First of all, there is the increase in purchasing power that goes hand-in-hand with currency appreciation. Appreciation boosts private consumption and, hence, domestic demand. In a working paper recently published by the IMF, the authors Guo and N´Diaye took a closer look at private consumption in China. One of the conclusions that they reach is that a 10% appreciation of the real trade-weighted exchange rate of the renminbi would lift the share of private consumption in GDP by 2 percentage points. This is an important aspect, especially for China, where this share has been gradually declining in the past few years. It recently stood at only about 35%, compared to just shy of 50% in the early 1990s. This puts China well below the international average. Private consumption usually accounts for between 50% and 70% of GDP.

Chinese consumption share well below average

Private household consumption as % of GDP (2009)



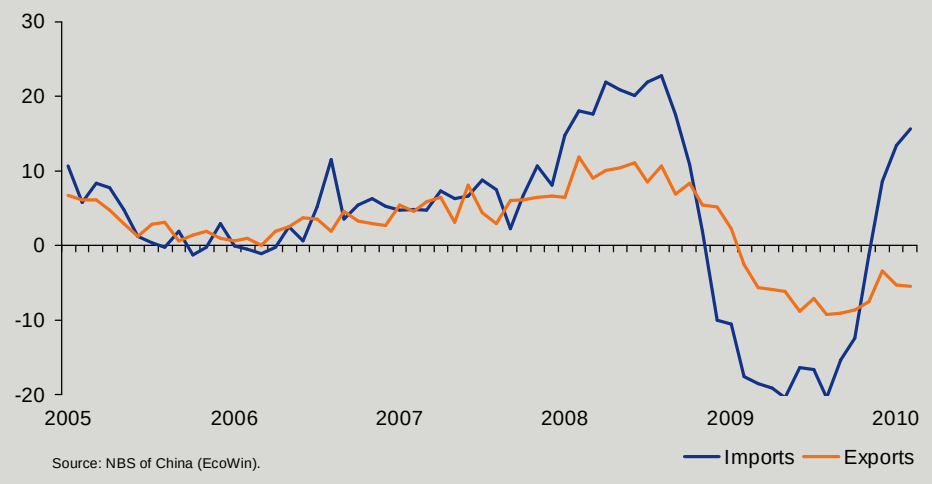
In June of last year, in our working paper entitled "Asia and the global economic crisis: Challenges and opportunities", we emphasized the need for changes to the Asian growth model and demonstrated, taking China as an example, how domestic demand could be boosted in the long term, making the economy less dependent on foreign trade. Our considerations stemmed from China's high gross national savings rate, which equates to more than 50% of GDP. If China were able to reduce this rate, consumption would automatically reap the benefits. The savings rate could, for example, be reduced through greater private participation in the corporate sector and development of the state social welfare system. In the overall context of the necessary changes to the Chinese growth model, gradual moves to make the renminbi more flexible could prove to be a key, and most importantly an effective, addition to such moves.

The Asian economies would also benefit from the appreciation of their currencies thanks to the associated reduction in inflationary pressure, because the appreciation would bring down the price of imported goods in national currency terms. Given the brisk economic recovery in Asia and the substantial rise in commodity prices, the increase in consumer prices has picked up speed in some countries in recent months. In Thailand, the inflation rate in the first three months of 2010 averaged 3.7% compared with the previous year, after prices had been on the decline for much of last year. In China, inflation slowed slightly to 2.4% in March (compared with 2.7% in the previous month),

but remains clearly on an upward trend on the whole. Imports are a source of particular pressure: import prices in February were more than 15% higher than they were at the same time last year. Dynamic development on this scale has not been witnessed since September 2008.

China: Steep rise in import prices

Export and import prices, % change over previous year



The inflation damper associated with currency appreciation brings yet another positive effect along with it: all other things being equal, appreciation reduces the extent to which the central banks have to raise key interest rates. Due to its role as an economic forerunner and the robust nature of its recovery, Asia is making moves to lift its interest rates earlier than others. In light of this, and given that interest rates in the world's industrialized countries are likely to remain on the low side for the foreseeable future, more short-term capital flows, in particular, will be headed in the direction of Asia. But not least since this "hot money" can flow back out of a region just as quickly as it flowed in (for example, if moves to tighten interest rates in the G3 countries are made sooner than expected and prove to be more considerable than expected), these very volatile capital flows pose a not insubstantial risk to the stability of economic development in the recipient country. Currency appreciation would make the interest rate differential between industrialized countries and emerging markets less pronounced than it would be without appreciation, restricting the incentive for portfolio investments in the region to at least some degree.

IMF recommendations given the high capital flows into the emerging markets

In its most recent "Global Financial Stability Report", published in April 2010, the IMF devotes an entire chapter to the issue as to how, as a general rule, countries with relatively low interest rates and a positive economic outlook (i.e. emerging markets) can best cope with the global liquidity that is flowing their way. The first of the possible options picked out by the IMF is a more flexible exchange rate system, particularly if a currency is undervalued. The IMF also refers to interest rate cuts as a possible option, provided that a country's inflationary environment allows them. At least for the time being, however, this cannot be considered a real option. In the IMF´s view another way of solving the problem would be to facilitate the flow of capital out of the affected countries, a move that would go some way to balancing out the capital inflows from abroad.

In the IMF's view, restrictions on the movement of capital are justified only if the measures described above prove insufficient, and if, at the same time, the country in question has to assume that the capital inflows will not be a permanent feature. This recommendation is interesting because the IMF was long considered a strict opponent of restrictions on the movement of capital. In recent years, however, there has been something of a change of heart at the Fund. When Malaysia, for example, implemented capital controls in the aftermath of the Asian crisis of 1997/1998, it was vehemently criticized by the IMF. It was only many years later that it admitted to Malaysia that restricting the movement of capital had proven to be the right move, and that it was one of the reasons why the South-East Asian country had made such a rapid recovery after the crisis. Nevertheless, the IMF points out in its current report that there is no clear evidence suggesting that restricting the movement of capital is effective. There are, for example, some indications that these controls do not reduce the total volume of capital inflows, but rather merely extend the period of time in which the inflows occur. The IMF also reiterates that, even if restrictions on the movement of capital work for an individual country, they can still be harmful from a multilateral perspective. If, for example, a country limits the inflow of capital from abroad, this is likely to "divert" international capital flows to other countries. Ultimately, these countries may also feel urged to impose capital controls. The IMF points out that, if a substantial number of countries resorted to such restrictions, there would certainly be a risk of the individual countries putting necessary macroeconomic adjustments on hold. Given the current global economic situation, this could ultimately put a halt to moves to eradicate global imbalances – something that is absolutely essential, an assessment with which we concur.

Coordinated exchange rate policy in Asia?

One of the main reasons why Asia's emerging markets have opted to intervene on the currency markets in recent years has been their fear of becoming less competitive than their neighbors. So it is obvious that we can only expect to see any considerable transition to a more flexible exchange rate policy in the region as a whole if the largest country in the region, namely China, decides to make such a move. A coordinated exchange rate policy would resolve the "who blinks first" dilemma. Given the (in some cases substantial) differences in the level of development of Asia's emerging markets, however, this could only be achieved in the form of a very loose cooperation on issues relating to exchange rate policy. One aim, for example, could be to come to an agreement on a joint, gradual appreciation plan for Asia's currencies.

There is no doubt that coordinated appreciation measures taken by several major Asian emerging markets would help to ease global imbalances. A study conducted by economists Thorbecke and Smith, to which the ADB refers in its "Asian Development Outlook 2010" publication, concludes that the appreciation of the Chinese renminbi alone would only have a very limited impact on regional trade. If, however, the currencies of East and South-East Asia were to be revalued in a concerted effort, the upheaval would be greatly reduced, particular as far as China is concerned. Based on panel data for 33 of the countries that buy Chinese products, Thorbecke and Smith show that a 10% revaluation of the renminbi would reduce Chinese exports of manufactured, capital-intensive goods by less than 4%. If , however, all of the currencies of East and South-East Asia were to be revalued by 10%, the drop in exports would come in at around 10%.

As we have shown, moves to make Asia's exchange rate policy more flexible can play a key role in helping to reduce global imbalances. It would, however, be a fallacy to believe that flexible exchange rates in Asia alone can solve the problem of global imbalances in

one fell swoop. At the core of these imbalances are not exchange rate systems, but rather the investment and savings patterns seen in those countries with current account surpluses and deficits.

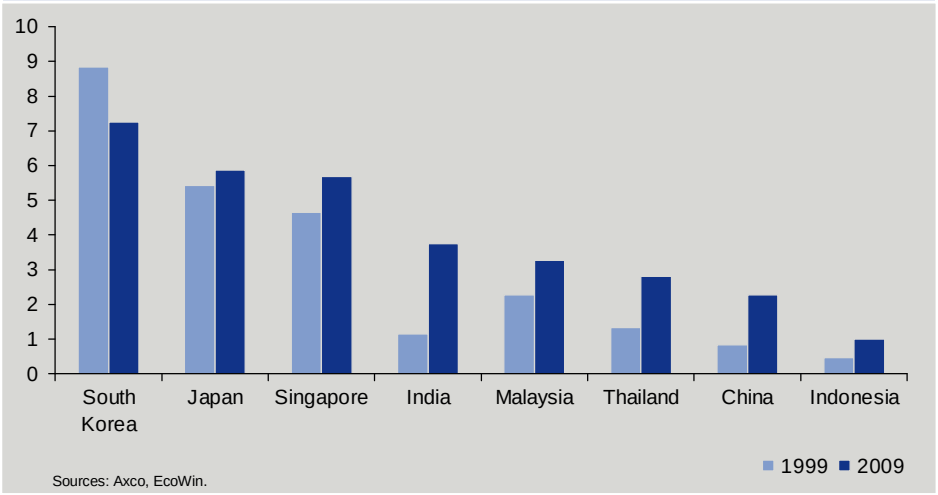
4. LIFE INSURANCE MARKETS – ASIA'S LONG-TERM GROWTH STORY

The life insurance markets in the region weathered the crisis fairly well. Of course the stellar growth rates seen in recent years tumbled, but premium growth rates in almost all countries were nonetheless in lower double-digit territory. The financial crisis was thus only a short-lived obstacle on the long-term growth path of life insurance in the Asian emerging markets.

In terms of total gross premiums, Japan is still the largest life insurance market in Asia, but the catch-up process in the Asian emerging markets is unstoppable. From 2015 China will be the leading market in Asia and India will have overtaken South Korea. Annual growth in premiums over the past ten years had already been well over 10% in many markets and in China, India and Indonesia average annual growth rates were actually close to 25%. Premium growth in the emerging economies easily outstripped GDP growth, with the result that penetration rates in the region have moved substantially more into line over the past ten years. South Korea, where insurance coverage is already very high, was the only country to see a drop in penetration. However, this does not mean that insurance premiums stagnated. On the contrary: average annual growth was still 4.6%.

Life insurance – penetration in emerging markets improved already

Gross written premiums in percent of GDP



Sources: Axco, EcoWin.

Over the next ten years most emerging markets will manage to catch up with penetration levels in the developed economies of the region. Nonetheless, even in 2020 the growth potential of the Asian emerging markets will still not be exhausted. This is exemplified by a look at gross written premiums per capita compared with GDP per capita. Japan leads the field here too, with EUR 2,343 premiums per capita and GDP per capita of EUR 28,571 (2009), closely followed by Hong Kong, Taiwan and Singapore. The gap over the small life insurance markets is much more marked than with penetration rates: China's premiums per capita stand at a mere EUR 56 and even by 2020 will not

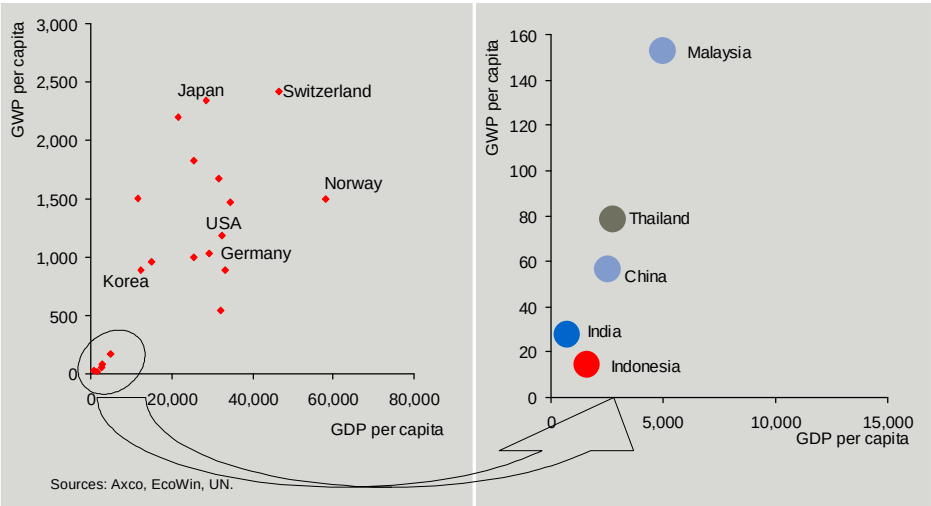
exceed EUR 400. In India the figure will climb to just under EUR 120 in ten years' time and in Indonesia to just over EUR 80.

A country's economic development and, above all, its prosperity level are key factors behind demand for insurance products. As a rule, once GDP per capita crosses a threshold of EUR 10,000, demand for insurance and asset management products rises sharply. Above all, as incomes rise, so do the sum insured and the premiums per policy. However, among the Asian emerging markets, only Malaysia will be close to this threshold in 2020. The catching-up process will therefore still take some time.

Demographic change in the region is a further driver of growth in life insurance demand. Although population growth in the region is declining sharply, many economies are still fairly young societies. Up to 2050 the group of 30-60 year-olds will rise steeply and it is in this very age group that demand for life insurance products is strongest. In addition, we are also witnessing a slow rethink in retirement provision, with a greater emphasis on private provision.

Life insurance – growth potential in emerging markets still far from exhausted

GDP and GWP per capita, in Euro 2009



China: Second largest life insurance market in Asia

The upswing in China has been accompanied by an upswing in the insurance market. Back in 2008 Chinese life insurance premium volumes already overtook those in South Korea and China became the second largest life insurance market in Asia after Japan. The lion's share of insurance premiums (67%) comes from the life insurance segment. But for China it is of course true that both the insurance density and the penetration rate of 2.3% are still below industrial-country level.

The market is dominated by three large national insurance companies, China Life, Ping An Insurance and China Pacific, whose combined market share stood at 62% in 2009. By contrast, the market share of foreign insurance companies stands at a mere 5.2%, reflecting the ongoing market access difficulties.

More than half of the premium intake still comes from traditional *participating products* and, lagging well behind in second place, come *universal life* insurances. Investment-linked life insurance accounted for only 6% of total premium revenue in 2008. The insurance component is thus still the most important reason for the purchase of life insurance whereas retirement provision and the savings motive play less of a role. However, this has already been changing for a number of years, as evident in the investment structure of financial assets. While in 2002 87% of financial assets were invested in bank deposits, this figure slipped to 63% by 2007 in favor of securities, above all in the course of the equity boom. The financial crisis and the slump in equity assets pushed the share of bank deposits back up to 78% in 2008. Nonetheless, the restructuring of financial assets in China is set to continue. Above all, insurance products benefited from this shift since they offer not only higher yields but also guarantees. As a result, their share in financial assets rose steadily to 7% (2008). As incomes rise and awareness of the need for private retirement provision grows, the share of insurance products in financial assets will climb further.

Indonesia: Full steam ahead

Although Indonesia is the third most populous state in Asia after China and India, the life insurance market is one of the smallest in both absolute and relative terms. With an insurance penetration of just under 1% and premiums of EUR 16 per head, the development potential is enormous. Even the financial crisis curbed the buoyant growth of recent years only briefly. We expect the life insurance market to grow by an average 20% a year in the coming five years and the success story to continue thereafter as well.

In contrast to China, savings and investment products are the most popular in Indonesia, generating 70-80% of premium revenues. The introduction of the risk-based capital system (RBC) prompted a shift away from traditional risk life insurance towards less capital-intensive investment-linked insurance products which now account for almost 40% of premium revenues. Mixed life insurance policies are the second most important product group with 38%. And although the Takaful insurance market is still in its infancy, it is expanding rapidly and has a rosy future in Indonesia with its more than 200 million Muslims.

Malaysia: Takaful on the advance

The insurance market in Malaysia is heavily concentrated, with the three largest insurance companies cornering close on 62% of the market. But in contrast to many other markets in Asia, foreign insurance companies dominate the scene with a market share of 70% (2008).

With a premium volume of EUR 5.4bn Malaysia is only marginally bigger than Indonesia but given its lower population it already has a much higher penetration rate of 3.3% (2009) and per capita premiums, at EUR 165, are above the Asian emerging market average.

With 34% of total premiums, *whole life* insurance products lead the field, closely followed by investment-linked products which have seen strong growth in recent years. Since 2006, however, the highest growth rates of over 25% a year have been recorded by Takaful products which now account for almost 7% of premium volumes. There are already eight Takaful providers in Malaysia and a further two licenses are to be issued this year. Going forward, Malaysian Takaful providers are keen not only to serve the more than 13 million Muslims in Malaysia, but are also vying to become the “Takaful hub” in the region.

Takaful – Sharia-conform insurance

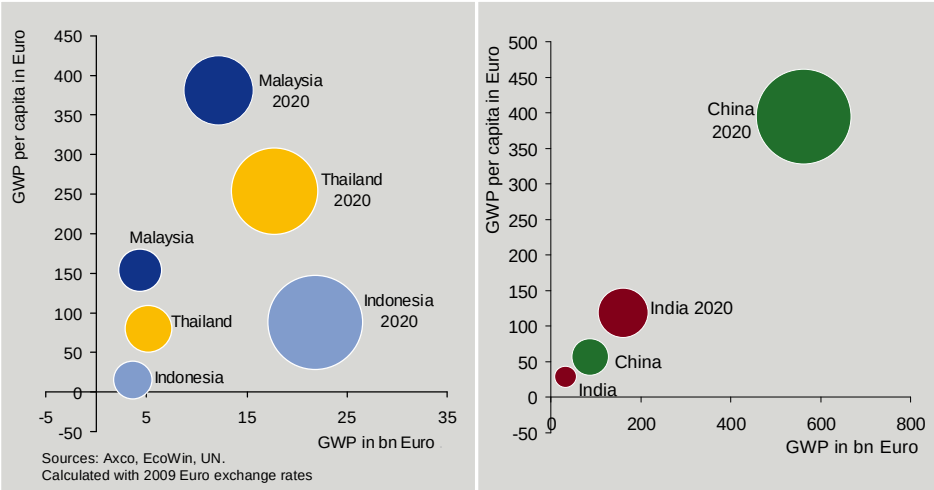
Estimates show 1.57bn followers of Islam worldwide – almost one quarter of the world population. Takaful is a community of insured people which shares out both risks and profits. The insurance company acts here merely as an administrator. According to sharia law, although profits are allowed, interest earnings by contrast are not, with the result that many devout muslims are unable to use traditional insurance products aimed at providing retirement provision and asset formation. In order to serve this large market, the first sharia-conform insurance products emerged in the early 1980s. But the real boom in Asia did not begin until 2004 in conjunction with the rising oil price and the economic upswing in Asia and the Middle East.

With Takaful life insurance products, insurance companies pay into a fund built upon Islamic principles which distributes the lion's share of profits. For instance there are special funds which invest only in company stocks which have no connection with alcohol, pork or tobacco.

Market data on the global Takaful market are scarce. 2007 estimates assumed a figure of EUR 4.6bn, with Saudi Arabia and Malaysia the biggest markets. Demographic developments in the Asian countries, rising incomes, greater individual awareness of the need to put more aside for retirement and the growing range of sharia-conform banking and insurance products will all serve to push up demand strongly in the coming years.

Life insurance – Asia today and in 2020

Market size and GWP per capita 2009 und 2020

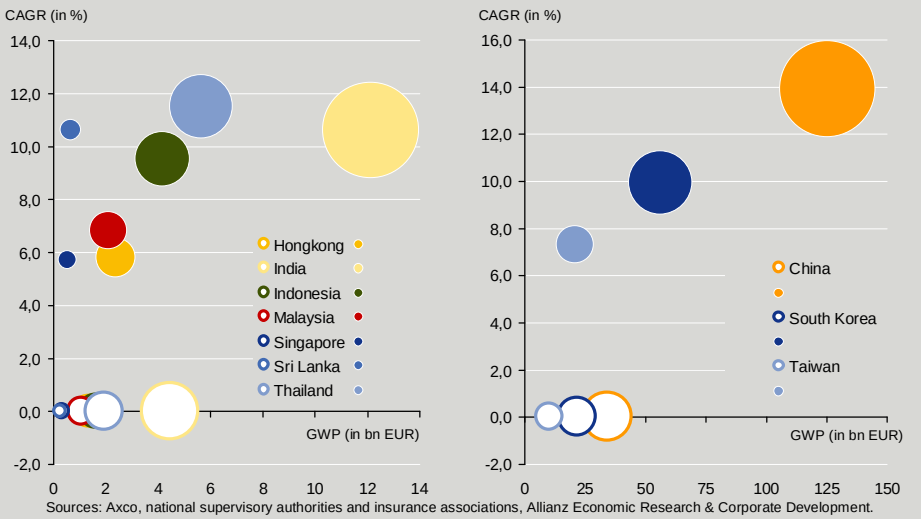


5. NON-LIFE INSURANCE MARKETS IN ASIA – HIGH MOMENTUM FUELED BY ECONOMIC GROWTH

Non-life insurance markets in Asia will be among the most dynamically growing markets worldwide in the coming years. Over the next ten years premium volumes in the region are likely to more than treble. From the middle of this decade the Chinese non-life market will be bigger than Germany's.

Dynamic growth in Asian p&c markets

GWP 2010 and 2020, average growth

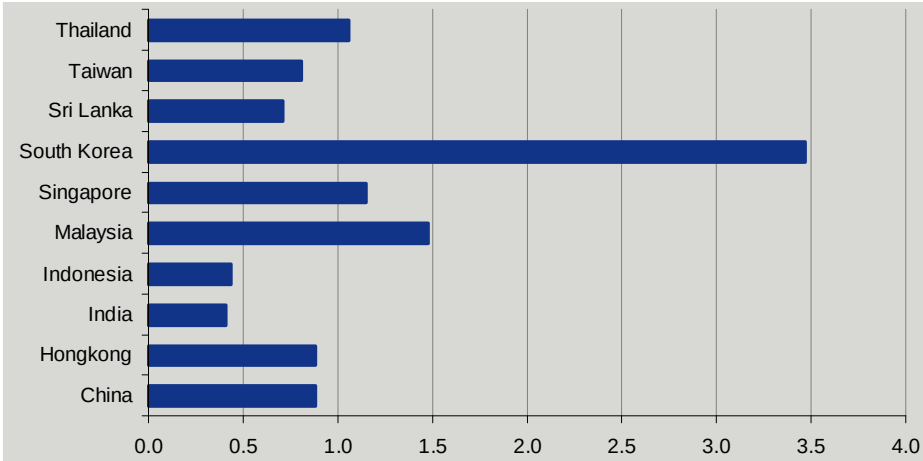


Sources: Axco, national supervisory authorities and insurance associations, Allianz Economic Research & Corporate Development.

This momentum stems on the one hand from economic growth and, on the other, from the fact that insurance markets in these countries are still in their infancy and are thus starting from a low level. With the exception of Malaysia, Singapore, South Korea and Thailand, insurance penetration, i. e. premium volumes in terms of gross domestic product, in all countries under review is below one percent. In India, for instance, alongside China the Asian country likely to record the strongest growth in the coming years, insurance penetration currently stands at a mere 0.4% of GDP. In South Korea, by contrast, it stands at 3.5%.

Insurance penetration

GWP as percentage of GDP

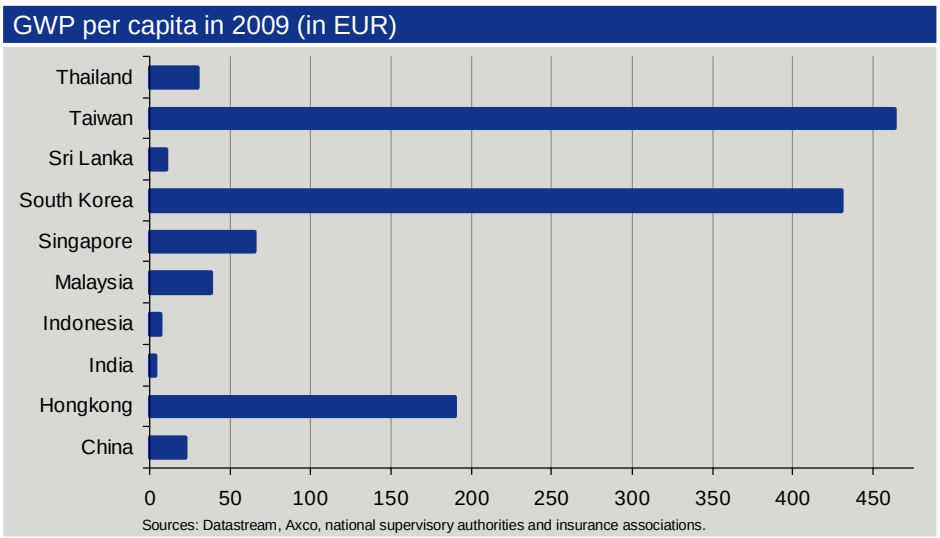


Sources: Datastream, Axco, national supervisory authorities and insurance associations.

Demand for non-life services corresponds closely with the level of economic development: the higher the prosperity and the non-financial assets of an economy, the greater the demand for insurance. In India gross domestic product per capita last year stood at around EUR 770, in China the figure was EUR 2600. In the Asian emerging markets non-life insurance density is currently correspondingly low: last year an Indian spent an average of EUR 3 on non-life insurance, whereas in Taiwan the average figure was EUR 460. In China the figure was EUR 22; however, as in the economy as a whole, the

insurance premium intake is unequally distributed: some 60 percent of total premium revenue is generated in the prospering coastal regions.

Insurance density in p&c markets



Typical for emerging insurance markets, alongside low penetration and density, is the high proportion of the motor vehicle insurance business in overall premiums: In India the share was 52% last year and in China more than 70% of premium revenues came from motor vehicle insurance. However, this should not conceal the fact that in many Asian countries, particularly in the rural areas, a large proportion of the population has less than EUR 2 a day to live on and thus cannot afford normal insurance protection. Microinsurance, available in some instances for 5 eurocents a month, can fill this gap. Together with CARE International, Allianz has been offering microinsurance in India since 2003. The policies cover, for example, risks such as accident, death, natural catastrophes and fire. Some two million people now have insurance protection. Experts believe that demand for microinsurance is also high in China and Indonesia. By 2015 there could be up to 12 million potential customers for life microinsurance products in Indonesia. Microinsurance will thus be a growth in the future as well.

As in many European markets, the financial crisis also left its mark on most Asian insurance markets. With the exception of China, where the market grew by 23%, and India, which saw an increase of 10.5%, most Asian countries recorded declining growth rates last year. However, this lull in growth is likely to be only temporary. In the coming years we expect to see average growth of 11%. China, India and Thailand are likely to lead the way. In those countries where penetration is already high – Malaysia, South Korea and Taiwan – we expect growth rates to average around 6%.

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These assessments are, as always, subject to the disclaimer provided below.