

Oil will bring a pinch, not slump

GLOBAL ECONOMY



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It's all been going quite well for a while. Asia, with Korea in the lead, delivered one of the most impressive economic recoveries in living memory. The region's economic output is now over a third higher than it was at the peak before the global financial crisis. Even Japan's earthquake, while immeasurably tragic, will in itself not derail the region's momentum. But there is a cloud on the horizon: oil prices. The cost of crude has risen sharply in recent weeks, partly reflecting political tensions in the Middle East. In the past, such price spikes have usually heralded a global recession. You only need to turn the clock back to 2008. Most attribute that year's economic slump to the financial shock stemming from the collapse of Lehman Brothers in the autumn. But, look closely, and you'll find that the sudden jump in oil prices, with one benchmark hitting almost \$150 per barrel over the summer, was equally to blame, depressing consumption and investment in Asia well before the spark of financial contagion hit.

So far this year, oil is up some 30 percent. And there may be more to come. Leaving aside developments in the Middle East, which are virtually impossible to predict, there are two other key drivers of oil prices. The first is the weak dollar. The greenback has been on a steep slide for some time now, pushing up everything denominated in it, notably the costs of raw materials, gold, as well as crude. This will continue.

But, what really matters for prices is the relative growth in demand. Here, China's appetite is rising so rapidly that it easily accounts for some 40 percent of the annual increase in global consumption. The balance, meanwhile, is entirely accounted for by other emerging markets, as demand in advanced markets is still stagnating. So far, there is little sign that growth is letting up across Asia, Latin America and other developing economies.

Of course, if price gains accelerate, the price shock would be felt more keenly. Still, markets seem calmer nowadays, lingering uncertainties notwithstanding. Second, while the dollar price of oil keeps climbing relentlessly, the rise in costs in local currency terms, say in won or renminbi, is not quite as painful. Exchange rate appreciation helps to buffer local economies and offers scope for further relief.

Perhaps more importantly, Asian economies are now on such a roll that they can take the rise in oil prices in their stride. With labor markets tight and wages rising, for example, motorists can still afford their gas, even if climbing costs are an understandable irritant.

This last point, however, highlights the real risk of rising oil prices. It is not so much local demand in Asia that is at risk, but spending in the West where incomes are hardly growing amid stubbornly high unemployment.

Higher gas prices, in this case, imply cut-backs elsewhere. Thus, the main risk for Asia, and especially for highly export dependent markets like Korea, is that shipments to advanced markets will take a hit.

Still, we shouldn't exaggerate the impact. The IMF, for example, estimates that if oil climbs to \$150 per barrel, and stays there through year-end, this would only shave 0.75 percentage points off the region's growth this year. That's a pinch, not a slump.

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The chairman of the Federal Reserve, Ben Bernanke, only recently confirmed that America's central bank is in no mood to tighten up any time soon. As a result, the dollar is bound to weaken further and, in the process, push the price of commodities higher still. The second driver of oil prices is the rapacious demand in emerging markets. China alone accounts for about 11 percent of global crude consumption, which is a little more than half of what the United States currently guzzles.

All considered, \$150 for a barrel of oil suddenly looks quite plausible. The question, therefore, is whether this would once again drag Korea and its neighbors into a nasty recession. Well, let's not panic.

First, it matters how quickly prices spike up. A gradual rise can be more easily digested, psychologically as well as physically. One difference between now and 2008, for example, is that the cost of crude is up only about 50 percent over the past year, but had doubled in the run-up to the global recession.

Chinese economy at a crossroads

GLOBAL ECONOMY



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An understanding of the growing asymmetries in the global economy has become essential to navigating the complex waters of global competition. The dispersion of economic and financial power across a larger number of countries is one of the main consequences of the crisis. Global imbalances are both a cause and a consequence of the crisis. The entire world is clamoring for a reduction of the large current account deficits in some countries and the large surpluses in others. Specifically, the unbalanced relationship between China and the U.S. lies at the core of global asymmetries. Multilateral agencies continue to insist on a resolution of these issues in order to lay a solid foundation for global economic growth over the long run, not just for the rich economies but also for China.

The Chinese economy grew at an annualized rate of 9.7 percent over the first quarter of 2011, compared to 9.8 percent during the same period in 2010 and an overall 10.4 percent during all of 2010. Domestic consumption accounted for slightly more than 60 percent of growth and the external sector reduced it by 4.4 percent, to a large extent due to an increase in the price and volume of imports. Inflation stood at 5.4 percent in

source of competitiveness. If China's growth slows down and inflation creeps above the usual levels, we could witness a significant reduction in its trade surplus with the rest of the world in general and the United States in particular. Domestic consumption could also be affected. The Chinese government is trying to anticipate the problems by restricting the supply of money and raising reserve requirements for banks.

ment boom both to create productive capacity and to create the infrastructure for sustained growth into the future. About 400 million people have been lifted out of poverty. While a substantial proportion of the population continues to be exposed to the vagaries of subsistence agriculture, the socioeconomic transformation is without parallel in human history for both its scale and speed. It goes without saying that the way in which China cools down its overheated economy will have an impact on other economies. South Korea and Japan might be the most affected if Chinese demand for its intermediate goods drops. The entire global economy, however, will feel the consequences given that last year China's contribution to global growth exceeded one third of the total. One should also pay attention to domestic dynamics in China. Slower growth and higher consumer prices might have adverse effects on certain social strata. The worst-case scenario is runaway inflation and a restrictive economic policy to cope with it.

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March in annual terms, the highest rate in 32 months. The most important background factor was not only the increase in commodity prices but also the rise of labor costs in the wake of the decision by the government to raise the minimum wage. China cannot afford inflation given that it undermines its most important

The goal is to slow down the growth in credit. It is also imposing price controls for certain consumption necessities. They may also let the currency appreciate. China may be reaching a crossroads. Economic growth over the last 30 years has been predicated on low-cost manufactured exports and an invest-

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Man in charge

Harboring tenacity to your goals



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Pawn to King Four! This expression may not be a familiar one to many who are strangers to the game of chess. But this is probably the most popular opening move in chess, a move attempting to control the center of the board. But behind

modern Korea. It is also quite possible to move from one path to another with several second chances. There are repeated opportunities for college entrance exams with multiple applications. Transfer of schools, or changing one's major is much more common with relative ease. But perhaps because of this, we see less and less of those who stick to their childhood dreams or lifetime objectives. More chances often foster attitudes to easily give up or seek easy ways out from often less palatable journeys to success. One can, therefore, argue whether such multiple chances are good or not. Rolls-Royce started its car business in 1906 and entered the aircraft engine field with the birth of the aviation era. But in 1971, with overburdening development cost of an engine technologically far ahead of its time, Rolls-Royce filed for court protection and was subsequently nationalized by the U.K. government. The engine, RB211, was the first

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this first move are many carefully planned strategies and tactics. Grandmasters of chess often make claims that they can foresee several moves ahead and they often ostentatiously display their brilliance by playing multi-player games simultaneously. But, playing chess is an execution of a strategy that often changes with dynamism depending on the moves and actions of adversaries. For many older generations, the path to success seemed quite straightforward. Decorous studies through a series of schools and colleges of reputation, and passing of several prestigious national exams often warranted promising bureaucratic careers. Failure to achieve the next level in that path often meant detouring to different hyperbolic lines often regarded as unsuccessful. Back then, available paths were limited and society and the education system were not equipped to hand out second or third chances. But Korea today is very different from those days of less and hurried of the past. The mindset of society has changed dramatically to the point where eccentricity is almost taken synonymous as being creative. Back stage dancers are among popular wannabes among youngsters and many parents accept such as being part of a healthy fabric of

successful engine with three-shaft design to better optimize the fan, compressor and turbine speeds and with latest technologies in material and thermal management. But even under bankruptcy and under government ownership, development of the engine continued and the RB211 became major power components for Lockheed L1011, Boeing 747, 757 and 767. The developed technologies and RB211 eventually paved the way for the birth of the most advanced large commercial engine, the Rolls-Royce Trent series, which powers all Airbus and Boeing's large jets of today and tomorrow. With continued success and market confidence, Rolls-Royce was again open to the public by the Thatcher government in 1987 and today it is among the world's most respected companies with more than \$16 billion in annual sales with \$100 billion in orders booked. Ability to offer multiple choices to all its members is a true mark of advanced societies. But the same society and environment should also harbour the tenacity to stick to its goals and objectives by individuals and corporations. The vigor and dedication to stick to its intended end is as important as the adaptability to make new Pawn to King Four in each nick and cranny of an unpredictable path.

Housing market key to bridging Korea's output gap

KOREAN ECONOMY



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The Bank of Korea's preliminary estimate put GDP growth in the first quarter of 2011 at 4.2 percent compared with the year-earlier quarter and 1.4 percent compared with the previous quarter on a seasonally adjusted basis. Growth rates are quarter-over-quarter, seasonally-adjusted unless otherwise noted. The 1.4 percent growth was a significant acceleration from the 0.5 percent pace of the fourth quarter of 2010. Manufacturing was the source of the stronger GDP growth and exports were the source of the stronger manufacturing growth. Exports measured in U.S. dollars

increased 9 percent in the first quarter, up from 5.6 percent in the previous quarter. They hit an all-time high of \$48 billion in March. Export-led growth is not new. Korea's post-Lehman crash export bounce was the biggest in Asia. It produced Asia's strongest recovery in industrial production. What is surprising is the failure of the V-shape recovery in industrial production to broaden into like recovery in domestic demand. As a result, Korea is one of the few Asian economies where an output gap — actual GDP below potential — persists. Korea's post-IMF crisis potential growth is 4.7 percent per year. The economy was operating at full potential a zero output gap in 2007. Growth was below potential in 2008 and 2009 and resulted in a 6 percent output gap. Above-potential, 6.1 percent growth in 2010 narrowed the gap to 5 percent. The strength of Korea's exports directs attention to weak domestic demand as the reason for the persist-

ent output gap. When we look at domestic demand we find the housing market at the center of the weakness. For one thing, residential construction, which peaked at 5.5 percent of GDP in 2003, fell to 3.4 percent in 2010. The 6.7 percent contraction in construction investment in the first quarter of 2011 suggests a further fall. Housing prices have begun to show some strength but the nationwide housing price index only recently moved above its year-earlier level while the index for Seoul and the surrounding area remains below its year-earlier level, a powerful headwind to

consumer spending. The headwind's impact can be felt in private consumption's declining share of GDP, from 55 percent on average in 2000-2007 to 51.8 percent in 2010 and 51.4 percent in the first quarter of 2011. There are some grounds for optimism. The authorities have tweaked their housing policies since the Lehman crash to boost the property market, most recently in March when they cut the home purchase tax rates by 50 percent. The recent uptick in house prices is a hopeful sign that the tweaks are bearing fruit.

Another hopeful sign is that the Bank of Korea is close to the end of its interest rate normalization. The interest rate for most mortgages in Korea is linked to the 3-month CD rate, which typically trades between 0.25 percent and 0.5 percent above the Bank of Korea's policy rate. The BOK has increased its policy rate by one percentage point to 3 percent and there has been a similar increase in the 3-month CD rate. If our forecast that the BOK will pause at 3.5 percent materializes, mortgage interest rate will stabilize. Finally, there is the reverse conun-

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drum. Readers may recall Ben Bernanke's invoking the "conundrum" to explain how the Asian saving glut depressed U.S. Treasury bond yields. In the reverse conundrum, the post-Lehman crash in U.S. Treasury bond yields is depressing Asian bond yields. The reverse conundrum arises because Asian central banks operate in the foreign exchanges to smooth fluctuations in their currencies against the U.S. dollar. The 10-year U.S. Treasury bond yield is down 1.1 percentage points since the Lehman crash and the 3-year Korea Treasury bond yield is down by 0.80 percentage points. If, as we expect given the weak prospects for U.S. growth and inflation, a retrenchment of U.S. Treasury yields is a medium-term prospect, it means an extended period of low Korean bond yields. The bottom line: prospects for a turnaround in the housing market and a closing of the output gap are improving.