

Voice of Asia

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Our *Voice of Asia* series brings to life the challenges and opportunities facing the region today and tomorrow. *Voice of Asia* is the result of significant collaboration across the Deloitte Asia Pacific and Global Network.

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Voice of Asia

A rich tapestry of insights

The Asian century is shaping, cultivating, and driving a dynamic future for business and society. Powered by almost 60 percent of the world's population, the region has become a hub of diversity and innovation.

Our *Voice of Asia* series brings to life the challenges and opportunities facing the region today and tomorrow. The potential has never been greater to create a cohesive narrative that reflects the interdependence of the region and provides a glimpse of what's possible across Asia, shaping a more positive outlook overall.

In this edition, we focus on key unifying themes—from growth to trade, culture to commerce—that underpin Asia's current and future prosperity.

This is *our voice*, the *Voice of Asia*.

2017 will be better than you think

Our first report is *Four things you need to know about Asia in 2017*. After years of disappointment, global growth may well be about to surprise on the upside, and despite the protectionist rhetoric issuing from the United States, it is Asia's economies that are in the box seat for the coming year.

But that's not what you've been hearing lately, because forecasters are still too gloomy. Whereas the International Monetary Fund still predicts only slow and fragile global growth, we see evidence that it could in fact accelerate, with leading indicators already pointing to a lift in world trade.

Asia's major markets of China and India are powering ahead, and growth in most other countries in the region is strengthening, while the United States is throwing off recent gloom and notching up its best performance since 2014.

At the same time, the Eurozone economy is edging up, and two of the world's other biggest emerging markets, Russia and Brazil, are showing increasingly positive signs.

This good news shouldn't be a surprise: It simply says that the global economy is finally normalising after a series of shocks that began with the global financial crisis and then, in quick succession, the Eurozone debt crisis and the geopolitical shocks in the Middle East, Europe, and Asia.

The leading indicators for world trade are rising, and the benefits of that are already spilling into Asia via accelerating export orders.

That's the beginning of a virtuous circle in which global growth triggers an upsurge in trade that, in turn, fuels stronger growth. Asia's emerging economies will be direct beneficiaries as they cash in on the growth of their major export markets and their own economic reforms.

Trump, trade, and tariffs

Our second report, *Trade to trump protectionists and boost global growth*, provides a more detailed analysis of the trade recovery now under way.

Of course, there are risks, with a cloud over global financial stability; rising geopolitical tensions in the Middle East, Europe, and Asia; and the surprise

election of Donald Trump, an unknown quantity, as US president.

And the biggest risk of all for Asia in 2017? That the global currency wars spill over into trade wars.

We see the continuing devaluation of the Chinese yuan as necessary, but it's possible that other Asian currencies will also fall—which could tempt the incoming US president to follow through on his protectionist campaign rhetoric.

As president-elect, Trump has toned down some of his initial campaign promises. Economists hope he will similarly water down his trade policy, which has the potential to severely damage US-China relations, undermine the competitiveness of US multinational corporations and their global supply chains, and trigger the global proliferation of protectionist measures.

Asia's additional line of defence—a healthy consumer

Nevertheless, Asia has another shield: If global growth isn't as strong as we expect, or even if trade tensions threaten to boil over, Asia's consumer is in remarkably good shape.

Our third report, *Asia's weapons of mass consumption*, shows how consumer booms are increasingly powering Asia's mega-economies, China and India.

A new and optimistic generation is taking its place in driving the direction of their economies: one that is technologically savvy, comfortable with the borderless consumerism of the global middle class, and yet imbued with the consumption-smoothing instincts of its parents and grandparents.

These new consumers are exactly what Asia and the world need right now. They're inherently optimistic and incredibly open to innovation and new ideas. They'll make enthusiastic importers as well as formidably competitive exporters. And yet, like consumers everywhere, they will be a stabilising force in their giant economies.

That means they're likely to play an anchor role for 2017 regardless of other developments.

What more could Asia or the global economy ask for?



Four things you need to know about Asia in 2017

IT'S easy to be gloomy. Global growth has disappointed for some time, and in recent years Asia has started to be part of that problem. The last decade has served up a seemingly never-ending succession of shocks, both political and economic.

So we've got some positive news for you: Much of the news in 2017 is more likely to be good than bad, with Asia set to be central to better-than-expected global growth this year.

But not all the news is good, so here are our four "need to know" insights for Asia this year:

- **First, global growth will surprise on the upside, with Asia—led by India—to be a substantial winner from that.** Leading indicators of global growth are on the rise as the big shocks of recent years settle into the rearview mirror, with that good news already bubbling up into a lift in export orders in Asia.
- **Second, while growth may be a pleasant surprise, financial stresses are a major risk factor.** Global interest rates are finally beginning their long climb back to normal, with the US Fed leading the way. That will generate a lot of volatility in markets, but our analysis suggests Asia is better placed than most to handle that stress.
- **Third, the best news within overall global growth will shift back in favour of emerging economies.** Even better, this won't be "lazy" commodity-driven growth. Reforms have boosted the underlying competitiveness of many emerging economies, setting the stage for more broad-based and sustainable, higher-quality growth.
- **Finally, the real shock for markets may well be a larger drop in the Chinese yuan.** China is juggling some key headwinds, leaving the authorities—in search of a growth booster—with little choice but to go for a much larger devaluation of the yuan.

Insight No. 1: Global growth will accelerate faster than expected, with Asia a big winner

Many forecasters, including the International Monetary Fund (IMF) and the World Bank, are warning that global growth will moderate, with risks tilted to the downside.

In our opinion, this is overly pessimistic. We see evidence that global growth will accelerate, not decelerate. Leading indicators show this and the underlying drivers of the global economy, such as labour and credit markets, already turning more positive.

And why wouldn't they? Consider:

- The G3 economies (the United States, Europe, and Japan) are all maintaining or increasing their rates of recovery.
- India continues to surprise by maintaining growth above 7 percent in the face of global headwinds.
- China is stabilising thanks to aggressive policy action to offset that nation's headwinds.
- Large emerging economies such as Indonesia are poised to accelerate, while others such as Russia and Brazil are set to recover.
- The net benefit of low oil prices is likely to be more evident in 2017. Positives such as higher consumer spending and the expansion of energy-intensive activities will begin to dominate over negatives such as collapsing oil-related capital spending.

Those are powerful positives.

World trade is rebounding: The early evidence

As figure 1 shows, world trade volumes have been in the doldrums for many years.

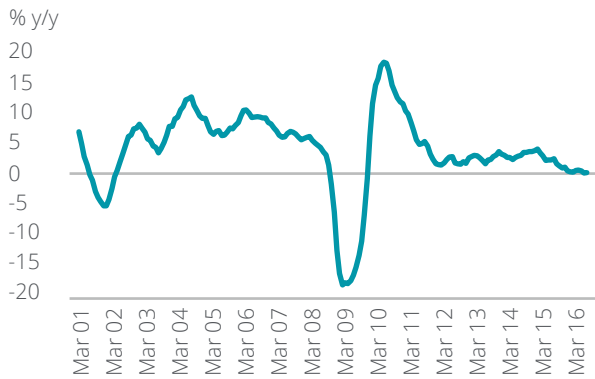
However, as figure 2 highlights, there are very early signs that US import demand is picking up.

And the leading indicators of world trade show that a gathering rebound is under way:

- **First, new export orders have been rising steadily**—a message that can be clearly seen in purchasing manager surveys around the world (figure 3). This burgeoning export recovery is supported by a rise in new export orders received by all sectors of the global economy, as figure 4 reveals. Moreover, export orders received by Taiwan, a bellwether for world trade, are looking healthy, while factory orders in Germany, another major global exporter, are also on the up.
- **Second, trade in electronics components** is another key lead indicator of world trade. With new US orders for computer and electronic parts rising (see figure 5), this too points to growth in Asia's manufactured exports.
- **Third, container throughput**, yet another leading indicator, is also recovering (figure 6).
- **Finally, air freight**, which also provides a gauge of future trade activity, is showing signs of life too. In fact, the growth of global air freight has accelerated to its strongest rate since early 2015.

Much of the news in 2017 is more likely to be good than bad, with Asia set to be central to better-than-expected global growth this year.

Figure 1. World trade volume growth 3MMA
World import volume growth poor



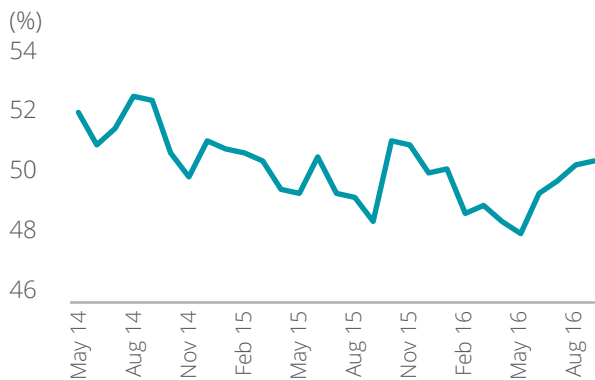
Source: Calculated using data from CPB World Trade Monitor.
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Figure 2. US import volumes
US import volumes: Incipient recovery



Source: Calculated using data from CPB World Trade Monitor.
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Figure 3. Global manufacturing new exports index
New export orders up...



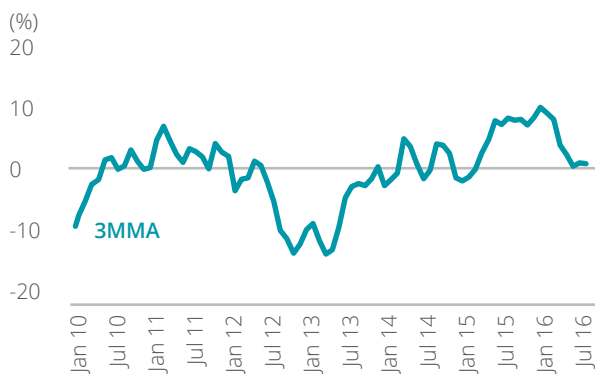
Source: Calculated using data from CEIC database.
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Figure 4. Global all industry new business index
...reflecting a general recovery in orders



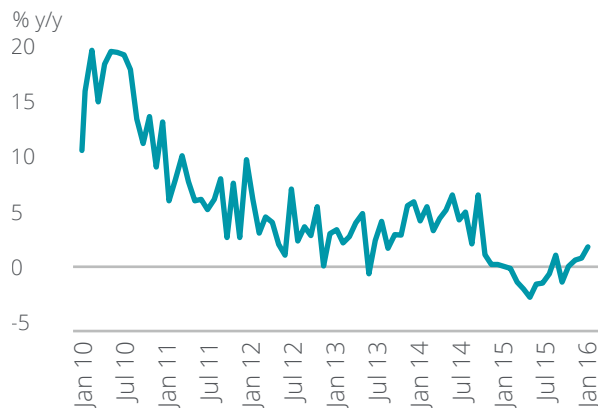
Source: Calculated using data from CEIC database.
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Figure 5. US new orders: Computer and electronic products
Electronics trade perking up a tad



Source: Calculated using data from CEIC database and RWI-Leibniz-Institut für Wirtschaftsforschung (RWI) and the Institute of Shipping Economics and Logistics (ISL).
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Figure 6. Container volume growth SA
Container volumes recovering



Source: Calculated using data from CEIC database and RWI-Leibniz-Institut für Wirtschaftsforschung (RWI) and the Institute of Shipping Economics and Logistics (ISL).
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Trade rebound underpinned by momentum in G3, India, and China

And there's more good news where that came from:

- **The United States is recovering its role as an engine of global growth**, with both manufacturing and services more robust. The US economy is growing at its fastest rate in more than a year, and the IMF is forecasting that growth to rise further in 2017.
- **The Eurozone is weathering its challenges:** The Eurozone has shaken off the shock of the Brexit vote and continuing political and financial uncertainty.
- **India's services exports are likely to benefit from the recovery in US growth momentum** as the United States continues to be the biggest market for Indian services.
- **China's recovery may be overly dependent on stimulus, but that stimulus is set to continue:** China has been on a firmer footing of late as the central government returns to its old playbook of debt-fuelled growth facilitated by cheap credit. It is concerning that the underlying structural weaknesses and risks that gave rise to the crisis of confidence in China a year ago remain unresolved. However, we also believe that public sector largesse can keep China's economy on a decent growth trajectory through 2017.

Other large emerging economies are bouncing back

But wait, there's more. The OECD lead indicators for Russia and Brazil suggest above trend growth likely over the next 12 months:

- **Russia's manufacturing purchasing managers' index** is close to a two-year high. Production is growing at its most robust pace in two years, and rising new orders portend continued growth.
- **Brazil's current indicators remain dismal, but forward-looking ones are improving:** The central bank is cutting rates, while lower oil prices, greater confidence in policy reforms, and an improving world economy are helping the Brazilian economy to bottom out.

The world economy is normalising after successive shocks

This set of good news in many ways has a single source—a lack of new crises.

The world economy is finally coming out of a dark period of successive major shocks. They began with the global financial crisis of 2008–09, but that was then followed by the Eurozone sovereign debt crisis from 2011, a succession of political crises in the Middle East centered around the Arab Spring, the sharp slowdown in Chinese economic growth and the subsequent collapse in commodity prices from 2014, and the ragged performance of large economies following that.

The election of Donald Trump as president of the United States raises some important questions for the global economy in 2017, including in relation to trade. Many of those questions are being asked elsewhere as well, as nationalist and protectionist sentiment proliferates across many developed economies.

However, the outcome may be far less dire than is being feared. As president-elect, Trump has toned down some of his initial campaign rhetoric; more important, there are limits to his influence when swimming against a rising tide of prosperity and globalisation, both of which will continue to provide an important stimulus for trade into the future.

What we are likely to overwhelmingly see through 2017 is the natural healing process that occurs in economies as the worst effects of these shocks wear off. This is forming a base for a more resilient recovery around the world.

The world economy is finally coming out of a dark period of successive major shocks.

The missing ingredient has been capital spending

An acceleration in capital spending in the United States would be big news. Pressed by the need to improve profitability, and as the recovering US economy provides more confidence that domestic risks and external risks such as Brexit and a Chinese slowdown can be contained, capital spending—the missing ingredient in a US recovery—could well revive.

The multiplier effect could be significant in Asia, including in India via increased trade in services. Large US financial institutions are the major consumers of Indian information technology services, and any genuine revival in the United States will lead to better opportunities for service providers.

Of course, this is no sure thing. American firms still face excess capacity and a rising US dollar, which hurts US exports. If business investment does take off, it will be because businesses are confident of a boost to demand and an uptick in inflation—both of which could be spurred by the sort of fiscal stimulus that president-elect Trump has suggested he might champion.

Asian exporters the big winners from global recovery

The sub-index for new export orders in purchasing manager indices across Asia are already on the rebound. That's an encouraging sign, indicating that global demand is slowly but surely gaining strength.

We see the relative winners among Asian economies as those with competitive manufacturing sectors:

- **Export-oriented newly industrialised economies will be the biggest winners:** Taiwan should benefit given its strong linkages to US technology products—but the strength of its recovery will also depend on how much of a turnaround there is in Chinese demand for Taiwan-made intermediate products. Singapore will be a major beneficiary too, given how trade-dependent that economy is. South Korea will benefit too, particularly if there is a rebound in global capital spending—but the rebound will be constrained by sector-specific challenges in its shipbuilding, shipping and phone sectors.
- **Export-oriented ASEAN economies stand to gain as well:** Malaysia has a competitive currency and a strong base of export-oriented manufacturing, and trade is a big share of the Malaysian economy—one of the world's highest such ratios. Thailand, too, will be a winner, as will Vietnam, although the Philippines and Indonesia are less competitive in export-oriented manufacturing.
- **Outsourcing will continue to gain:** We also see outsourcing, which has been a major engine of growth for India and the Philippines, strengthening despite the US election-related rhetoric around this topic. India's outsourcing industry remains dominant in the region, and has morphed into a broader ecosystem integrating voice support along with sales support and software development. Given the advances in the technological domain and the need to maintain profitability, the outsourcing industry is likely to continue showing impressive growth for both India and the Philippines.
- **China** is an obvious beneficiary from increased demand in the G3, but it is facing more protectionist barriers and some Trump-related question marks; **India's** manufacturers remain less geared to a pickup in G3 demand but nonetheless will be positively affected by a recovery in key export markets. Further, India's manufacturers have considerable potential to sell into newer markets and are already targeting African and Latin American countries.

Insight No. 2: The Fed to raise rates faster than expected, but Asia can handle it

It is clear that the US Federal Reserve is shifting away from its extreme reluctance to normalise interest rates, raising the question of whether the gradient of the rate hike trajectory will be steeper than expected. Some officials are now talking about the risks of not tightening early enough, while the data is pointing to renewed vigor in the US economy:

- There is now a risk that the United States could actually grow too fast and cause some asset markets to “become too ebullient”.¹
- Also, inflation is showing signs of picking up and is heading toward the 2 percent target.
- The surge in Purchasing Managers’ Index activity indicators; the continued, albeit modest, firming of the labour market; and the signs that capital spending—the missing ingredient in the US recovery—may be reviving, suggest the economy is in robust shape. If so, that makes continued ultra-low rates inappropriate.
- And if capital spending really accelerates, as we believe it will, the multiplier effects on the economy will be sizable.

What would higher interest rates mean for Asian markets?

If the US Federal Reserve does lob grenades at global growth in 2017, are the nations of Asia well prepared?

There are several important factors that will determine Asian economies’ resilience in the wake of a Fed rate hike.

Exposure to abrupt withdrawals of external capital: Risky assets such as emerging Asian stock markets and bonds will be re-priced if US interest rates rise and investors become more rigorous in assessing risks.

There are three ways to measure the degree of risk:

1. Countries with current account deficits are better off if the deficit is mostly funded by direct investment rather than volatile portfolio capital. Given that, *Indonesia remains vulnerable*.
2. Another measure is the share of a country’s easily sold securities owned by foreigners. That’s an indicator on which *Indonesia and Malaysia seem modestly vulnerable*.
3. A final yardstick is the extent to which short-term debt is covered by foreign reserves. At first glance Hong Kong and Singapore look vulnerable on this score, but that’s only because their large banking sectors exaggerate this ratio. Only Malaysia is moderately at risk here.

Susceptibility to rising interest rates: After a long period of very low interest rates, debt levels have expanded among families and businesses in Asia. Rising rates could hurt those who are over-leveraged. We need to look beyond just debt levels to assess the degree of risk here. If banks are well capitalised and there are few distortions in the economy such as asset bubbles, then the risk is lessened.

Apart from China and Hong Kong, we see little risk of this. The Indian economy has undergone some major changes over the last three years due to active policy action around managing this risk. However, financial markets still remain susceptible to a rise in US policy rates. The recent Fed hike is likely to mean capital moving toward the US markets as investors realign their portfolios. This has historically meant a weakening of currency and volatility in portfolio flows into India.

The bottom line: Resilience in the region has improved as countries have strengthened their economic fundamentals to reduce their susceptibility to global financial volatility. However, with the global economy more interconnected than ever before, no economy is completely insulated, and some are more vulnerable than others.

So although we think that much of Asia will be able to handle the impact of rising US interest rates, it will remain crucial for Asian economies to further improve their resilience.

Insight No. 3: A more competitive Asia roars back with higher-quality growth

Over the past few years, a bunch of factors led to emerging economies underperforming. That list includes political convulsions, unpredictable weather, a weak global economy, falling commodity prices and the short-term ill effects of reforms such as subsidy cuts and tax reforms.

However, with some of this bad news now dissipating, the large emerging economies are poised to lead global growth into the next decade—all the more so because the quality of their growth is improving. A number of factors are driving this:

- **Lazy commodity-driven growth is being reversed:** Low commodity prices have weighed on the trade and revenue positions of several emerging economies—a problem for Indonesia in particular. However, we believe that the damage from the commodity boom reversal has been done and commodity-related activity is beginning to see a recovery that could well extend into 2017. Second and more importantly, instead of reverting back to commodity dependence, nations are reinvigorating reform efforts to diversify their respective economies.
- **Strong policy action:** We are seeing stronger policy responses across the region as well, helping to boost economic growth. Government policies and spending are boosting private-sector confidence and are helping to generate a recovery in investment spending. That will create new capacity and further improve competitiveness.
- **Accelerated reforms:** These efforts are being complemented by necessary reforms to address the deep-seated structural weaknesses that have held back economic competitiveness and growth across Asia in recent years.

That's a good news story. Yes, Asia's growth has faced challenges, but a variety of responses look set to make a helpful contribution to the region's growth in 2017.

Taking stock of relative competitiveness

Global institutions frequently compare countries across a range of indicators in order to gauge their relative competitiveness and performance over time.

Across most competitiveness indices (see table 1), we see a recurring trend among Asian economies:

- Singapore leads its peers almost across the board.
- Malaysia and China fall in the middle.
- They are trailed by India, Indonesia, Philippines, and Vietnam.

However, an assessment of competitiveness over time suggests these trailing economies are on a rising curve thanks to the factors mentioned above. We can see this partly by comparing their ranking in the World Economic Forum's Global Competitiveness Index, which gauges competitiveness by assessing a wide range of key aspects that matter for competitiveness. That index measures competitiveness based on criteria ranging from institutions and the macroeconomic environment to innovation and business sophistication.

As the years of “lazy” commodity-driven growth recede, governments are being forced to undertake reforms that improve long-term fundamentals—and the payoff looks to be just around the corner.

Table 1. Regional competitiveness comparisons

Ranking	Global Competitiveness Index (WEF) (2016-17)	World Competitiveness Index (IMD) (2016)	AT Kearney FDI Confidence Index	WB Logistic Performance Index (2016)	WEF Travel and Tourism Competitiveness Index (2015)
Indonesia	41	48	N.A.	63	50
China	28	25	2	27	17
India	39	41	9	35	52
Malaysia	25	19	N.A.	32	25
Philippines	57	42	N.A.	71	74
Singapore	2	4	10	5	11
Thailand	34	28	N.A.	45	35
Vietnam	60	N.A.	N.A.	64	75
Australia	22	17	7	19	7
New Zealand	13	16	N.A.	37	16
Japan	8	26	6	12	9
Korea	26	29	17	24	29

Source: Collated from various sources.

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Countries	2006-07	2011-12	2015-16	2016-17	Change to 2016-17
Singapore	5	2	2	2	0
Japan	7	9	6	8	-2
Korea	24	24	26	26	0
India	43	56	55	39	16
China	54	26	28	28	0
Australia	19	20	21	22	-1
New Zealand	23	25	16	13	3
Hong Kong	11	11	7	9	-2
Taiwan	13	13	15	14	1
Indonesia	50	46	37	41	-4
Malaysia	26	21	18	25	-7
Philippines	71	75	47	57	-10
Thailand	35	39	32	34	-2
Vietnam	77	65	56	60	-4

Source: World Economic Forum Global Competitiveness Index rankings 2016-17.

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India makes the largest gains: India was one of the region's only two countries that showed an improvement in the World Economic Forum's competitiveness index in 2016. It rose 16 positions, moving up to rank 39th out of 138 countries. The improved performance was underscored by progress across all sub-components of the competitiveness index, notably so in market efficiency, business sophistication, and innovation. The cumulative reform efforts of the Modi administration are clearly easing the constraints to doing business in India. The last year in particular has seen some key legislations pass, the implementation of which will likely have a noticeable effect on competitiveness in the coming years. In May 2016, the government passed the "Insolvency and Bankruptcy Code 2016," which will enable insolvency to be settled on a timely basis, create a record of serial defaulters, and allow faster turnaround for businesses in India. Another key reform has been the passage of the "Goods and Services Tax Bill August 2016," aimed at converting India into a unified market with four indirect tax rates across all states. This is expected to be the biggest game changer in India's tax regime in recent times and is likely to result in increased competitiveness for Indian producers.

New Zealand has improved quickly, while Australia has lost ground: Australia's ranking in the World Economic Forum competitiveness index slipped back in 2016–17 to tie its previous worst position of 22nd out of 138 countries. Key drivers of the result were innovation, where Australia continues to slip behind developed economy peers on the World Economic Forum measure, and a relatively high corporate tax rate. In contrast, New Zealand has rocketed up the rankings in recent years, reaching 13th place in 2016–17. That compares to the country's 25th ranking just five years ago. Although New Zealand also ranks behind other developed economies in terms of innovation, the country was ranked first in 2016–17 for financial market development, time taken to start a business, efficacy of corporate boards, and the strength of investor protection.

Indonesia is improving but remains an economy of contrasts: Indonesia fell five positions in 2016, ranking 41st overall. The macroeconomic environment, financial market development, and innovation have improved markedly, but Indonesia is still languishing in health and basic education, as well as labour market efficiency and technological readiness. However, prospects are better than ever. The Jokowi government has already launched 13 economic policy packages to improve Indonesia's business environment. When coupled with both the government's plans to continue improvements in health and education and the increased technology uptake across firms, the new policies will be amplified and translate to higher growth.

The Philippines fell in the rankings for the first time in a decade: With bureaucratic red tape, corruption, and infrastructure bottlenecks hampering competitiveness, the Philippines slipped 10 places in 2016 to rank 57th, the first time in a decade that the nation has fallen in these rankings. Other weaknesses identified included the country's low goods market efficiency, poor technological readiness, and inadequate infrastructure. Still, with a robust macroeconomic environment and a competent economic team focused on improving these fundamentals, we are likely to see improvements in areas such as infrastructure and eased investment restrictions.

Vietnam displays short-term weakness: Vietnam fell four spots in 2016 to rank 60th, following a climb up the competitiveness ladder since 2012. Vietnam reported poorer performance in the criteria of macroeconomic environment and labour market efficiency, but the long-term outlook is positive. Better infrastructure and education limited the rank slippage. Also, Vietnam is growing into a manufacturing powerhouse, supported by surging foreign direct investment.

The bottom line: As the years of "lazy" commodity-driven growth recede, governments are being forced to undertake reforms that improve long-term fundamentals—and the payoff looks to be just around the corner. With competitiveness already improving, these reforms will produce a surge in Asian competitiveness in coming years that will further boost the region's growth prospects.

Insight No. 4: The real shocker for Asia: A devaluation of China’s yuan

Financial markets have gotten over their shock at China’s sudden move to weaken its yuan in mid-2015. The Chinese authorities have pursued a strategy of a steady but unpredictable pace of depreciation that currency markets have taken in their stride.

However, chances are that the markets haven’t seen anything yet: Conditions are falling in place for a currency move that might be more unnerving.

China: Buying short-term growth at the expense of longer-term stability

The Chinese economy is back on a relatively stable footing and probably hit its 6.5–7 percent target range for growth in 2016. The recent shocks of the stock market rout, the yuan’s sudden devaluation, and the subsequent flight of capital in 2015 now seem to be behind us. According to the official data, the economy has been growing at a steady annual rate of 6.7 percent (see figure 7).

But China has paid a price for this nascent stabilisation. It has come on the back of aggressive fiscal and monetary stimulus directed by the central government, channeled through local

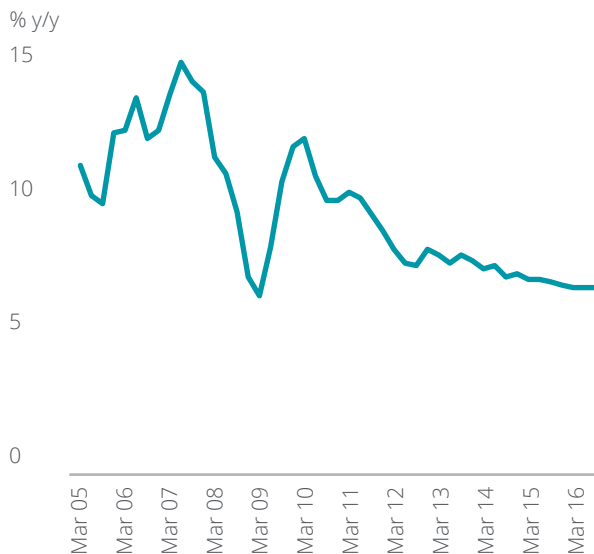
governments and state-owned enterprises and bankrolled by large, government-linked financial institutions. Desiring a cyclical boost to put the economy on firmer ground, policymakers have turned back to their old playbook of debt-fuelled growth, facilitated by monetary easing measures by the People’s Bank of China.

As a result, China’s ratio of total debt to GDP has soared, jumping from around 200 percent in 2010 to just under 300 percent in 2015, with much of the new leverage extended to the corporate sector. In a monetary system with a weak credit culture, this is risky.

Consider the following:

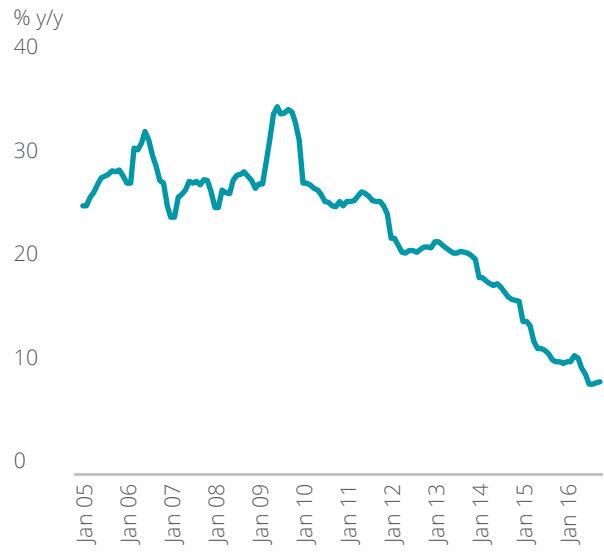
- Much of China’s debt was extended to state enterprises which used it to fund more excess capacity. But as excess capacity built up, pricing power fell, and as a result, so did profit margins and cash flows. Unsurprisingly, there is growing evidence of financial stress.
- Distortions also have built up in the financial sphere. For example, the P2P sector has grown wildly, with P2P loans surging more than 150 percent in the past year—but with more than a third of them experiencing operational problems.

Figure 7. China: Real GDP growth
Declining growth but now stable



Source: Calculated using data from CEIC database.
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Figure 8. China: Fixed assets investment, YTD
Persistent deceleration in investment



Source: Calculated using data from CEIC database.
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- The liabilities of well over 100,000 companies owned by local governments across the country grew at an average annual rate of 14 percent from 2012 to 2015, to reach USD 5.3 trillion.
- Moody's has warned that small and medium-sized banks are increasingly relying unhealthily on wholesale funds, which reportedly now account for a third of their financing.

Reaching the limits of the current policy mix

Other challenges limit the effectiveness of China's traditional mix of fiscal and monetary tools:

- The economic revival has been overly dependent on the buoyant property market, particularly in first-tier and popular second-tier cities where prices have skyrocketed unsustainably. The likes of Beijing and Shenzhen saw their prices lurch upward in 2016. This is being fueled by rampant credit growth that the government is now trying to rein in, fearing the potentially destabilising consequences of a housing bubble.
- And there's a growing problem: Credit-based stimulus is increasingly less effective in boosting growth. This means that there has been little real economic growth to show for all the liquidity that has been unleashed; this liquidity has increasingly been funneled into speculative areas, creating distortionary bubbles.
- In addition, the necessary deceleration of fixed asset investment will weigh on growth prospects, given that investment constitutes about 50 percent of the economy. The extra leverage that policymakers have unleashed has simply added even more capacity to an economy already saddled with chronic industrial overcapacity, which will deter private investment.
- Confidence in the long-term outlook remains a scarce commodity. Capital flight from China has ebbed somewhat but continues in various forms, through alternative avenues, reflecting still-sharp concerns about downside credit and growth risks. Businesses and individuals are employing a variety of ways to move cash out of the country. One popular way is through over-invoicing by Chinese companies for imports from Hong Kong. Another way is via the purchase of life insurance products in Hong Kong. Mainland Chinese circumvent capital controls by paying for expensive insurance products and then cashing out of these policies soon after in Hong Kong.

The underlying weaknesses in the Chinese economy mean that capital outflows will likely continue; this may, in turn, put downward pressures on the yuan.

This increasingly leaves policymakers with no choice but to surprise markets with a devaluation

Fiscal policy will likely be stepped up to ensure that China does not fall off its growth trajectory; more government spending on infrastructure and social welfare will likely be announced in the near future.

However, given the headwinds facing private investment (which makes up almost a third of the economy), this alone may not be enough. Policymakers will likely recognise that stimulating domestic demand comes with a heavy price and feel the need for stronger exports to drive economic growth.

At some point, a currency depreciation may be considered necessary; the key question is the magnitude of that depreciation. Given the People's Bank of China's tightening of outflows, it is unlikely the yuan will fall more than 5–7 percent against the US dollar.

However, a larger-than-expected depreciation of, say, 10 percent—which cannot be ruled out—would have a disruptive impact on the region. It would certainly cause Asian currencies to depreciate across the board, with manufactured-goods exporters such as Korea, Taiwan, and Malaysia most affected. Such a policy response is perhaps warranted by China, given its challenges of reflating the economy and cutting spare capacity, and might trigger a competitive devaluation by Japan.

Such competitive devaluations could drive the dollar to a level detached from underlying fundamentals, resulting in delays of necessary rate hikes. Indeed, the US dollar is already experiencing considerable upward pressure and could appreciate further if fiscal and monetary policies evolve in line with market expectations. An elevated dollar would mean a cheaper yen (a good thing for Japanese exports), further downward pressure on the yuan, weaker US exports, higher inflationary pressures in Asia, and difficulties for Asian companies with large US dollar-denominated debts. Such a scenario would present problems for many Asian economies yet also provide some opportunities.

However, one thing is clear: It is becoming less realistic to expect China to repeat its pledges of strong economic growth and a stable currency in order to ensure regional stability, as was the case during the Asian financial crisis. In the long run, most Asian economies will benefit from China's successful rebalancing of its economy.

Let's finish where we started

There has been plenty of doom and gloom. The political and economic shocks of the last decade have, no question, contributed to slower growth and undercut confidence.

But the doom and gloom is overdone. Much of the news in 2017 is more likely to be good than bad, and Asia is well placed to play an important role in driving better-than-expected global growth this year.

1. Adam Samson, "Fed's Rosengren sees 'reasonable case' for rate rise," *Financial Times*, September 9, 2016, www.ft.com/content/d04a6c2d-d88d-30dd-8b82-84ce95abc38d

Much of the news in 2017 is more likely to be good than bad, with Asia set to be central to better-than-expected global growth this year.



Trade to trump protectionists and boost global growth

TRADE has been part of the engine driving the emergence of Asia on the world stage. But it has been labouring for the better part of a decade. And although trade's troubles are global, they've been biting deepest here in Asia, where trade flows stalled a few years back.

To date, most of those challenges have been economic. But the political challenges to trade are also mounting fast, with Trump's anti-free trade agenda joining the Brexit revolution and question marks mounting in Europe, where the European Union faces a gauntlet of elections.

So will trade flows continue to lose steam, and drag down Asia's 2017 prospects with it? The answer is no. In fact, Deloitte sees trade about to regain momentum for several reasons:

1. **Trade's troubles were mostly temporary anyway**, damaged by successive crises and shocks, the effects of which are finally wearing off.
2. More importantly, **a bunch of those troubles aren't really trade-related anyway**. The big fall in commodity prices in recent years—cheaper oil, gas, iron ore, and coal—undercut measures of the monetary value of trade. But commodity prices have since surged, and that artificial negative is disappearing fast.
3. **India's services export story is still intact** despite a marginal slowdown and political posturing from the United States.
4. China's economy is lifting—indeed, that's why commodity prices have surged. And **China's recovery suggests that trade's recovery will follow suit in 2017**.

And there are some trends that will favour trade into the future:

1. **Policies have swung toward openness in the mega-economies of the future.** Looking longer-term, Asia’s potential will increasingly swing toward economies such as Indonesia, Vietnam, and the Philippines. Although these economies have low trade multipliers, the sheer pace of growth in the years to come will see their rise as part of the global trade story.
2. Just as the establishment of the European Union led to a large increase in trade within Europe, **closer integration and connectivity within Asian economies will be a dominant influence on trade volumes over the coming decade.**
3. Finally, **services are the new black.** The global momentum in trade is swinging away from goods—where the populism of protectionists can do the most damage—toward services. Faster recovery in the United States and Europe can lead to greater services trade benefitting the Asian economy.

There are no guarantees, of course. However, President Trump’s influence on global trade volumes over the next few years may be smaller than many imagine, while the powerful forces within Asia and elsewhere point to trade strengthening over time.

Trade matters—a lot

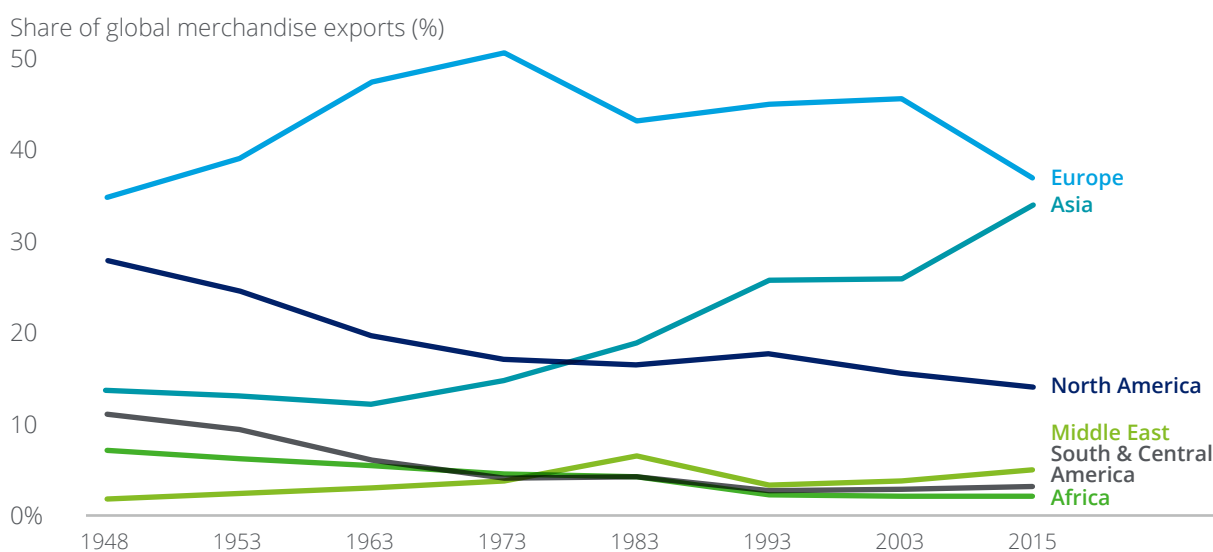
Trade is the lifeblood of the global economy. It is a barometer of economic health, an enabler of economic development, a facilitator of technology transfer, and a mechanism for productivity improvements and income growth.

It is also a sprinter. 2017 marks exactly 200 years since David Ricardo proved that there are great gains to be had from trade, and that is exactly what has happened since. Global trade has grown half again as fast as the global economy over the past 50 years, doing better still—at twice the rate of economic growth—over the two decades from 1987 to 2007.¹

The rapid pace of growth in global trade has arguably been more important for Asia than any other region. The transformation in Asia since the Second World War has been remarkable, starting with Japan and followed in quick succession by the “tiger” economies of Singapore, Hong Kong, South Korea and Taiwan, then China, and now other Southeast Asian economies such as Malaysia, Thailand, Vietnam, and Indonesia.

The common thread through these phases of economic development in Asia has, in general, been a reorientation of each economy toward an outward, export-focused strategy. As figure 1 shows, Asia now accounts for around one-third of global trade.

Figure 1. Regional shares of global merchandise exports



Source: World Trade Organisation.

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The fact that global trade growth has outpaced global economic growth at a time when Asia has been going through a profound economic transformation has been hugely beneficial. It has allowed per capita income growth in Asia to accelerate faster than it otherwise would have, contributing to lifting millions of people into the middle class.

Why global trade has slumped . . .

Since the global financial crisis, however, global trade growth has slumped. The financial crisis in 2008 was a massive shock for the world economy and severed many of the traditional economic relationships and linkages; global trade volumes plummeted in 2008 and 2009 (as seen in figure 2).

While trade flows have resumed a positive trajectory, their growth has been strangely subdued. The latest data suggests that global trade growth will slow in 2016, with the World Trade Organisation estimating growth on the order of 1.7 percent, the slowest pace since the global financial crisis.

That's not necessarily surprising. Indeed, it makes sense that trade growth has moderated alongside soft global economic growth.

More concerning still is the deceleration in global trade growth relative to global growth. After all, it was the sustained outperformance of trade growth compared to global growth over the previous

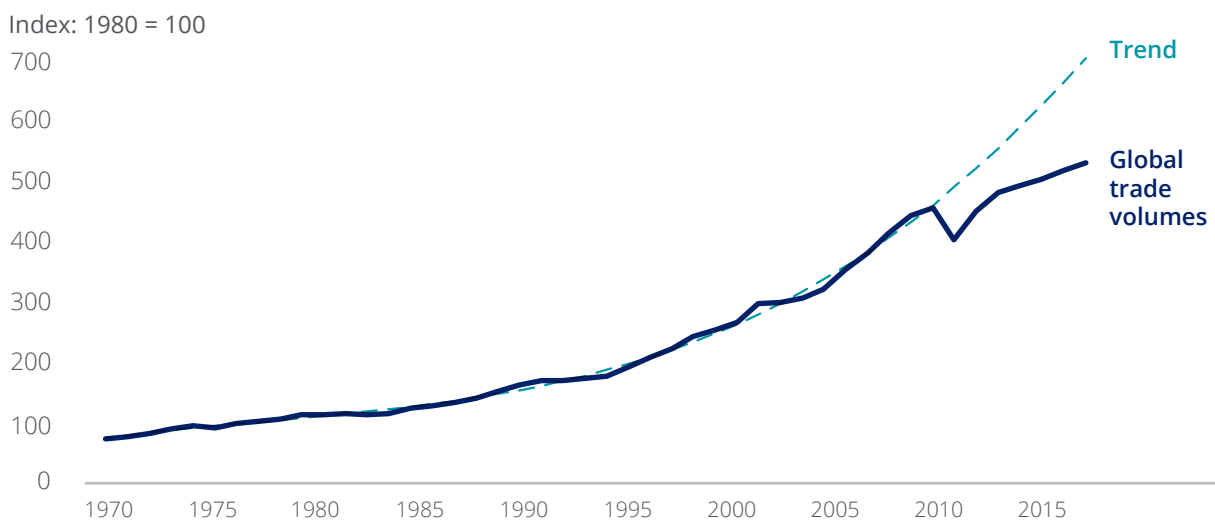
This is the first time in decades that global trade growth has been less than global economic growth for a sustained period, and that is having significant implications for the global economy.

half-century that so meaningfully supported development in Asia.

International Monetary Fund data covering the last five years shows that the global trade elasticity—the ratio of trade growth to economic growth—has been approximately equal to 1. Looking at just the last three years, the elasticity has been less than 1.

This is the first time in decades that global trade growth has been less than global economic growth for a sustained period, and that is having significant implications for the global economy.

Figure 2. Global trade



Source: World Bank; Deloitte calculations.

Note: Global trade measured in terms of total imports, real terms.

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... with Asia taking a major hit

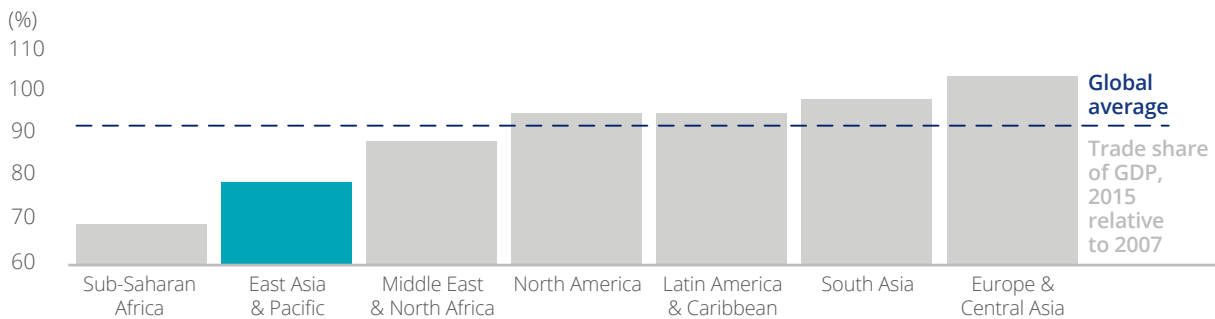
Just as the rapid expansion of trade over time was of huge benefit to Asia, the relatively slow growth in global trade since the financial crisis has hit the region hard. Figure 3 below shows how the trade intensity of different regions (measured by trade as a share of an economy, or the trade-to-GDP ratio) has changed since the onset of the global financial crisis. As a measure of this change, the figure simply shows the trade to GDP ratio in 2015 compared to the ratio in 2007.

Part of the trade slowdown is structural

Over recent decades, emerging economies, particularly those in Asia, have contributed a rising share of global growth. Figure 4 shows that, in the early 1980s, emerging market economies contributed around one-third of global growth.

In the last five years, the contribution from emerging economies has increased to around three-quarters of global growth and is expected to remain at about that level over the medium term.

Figure 3. Change in trade to GDP ratio, 2007-2015

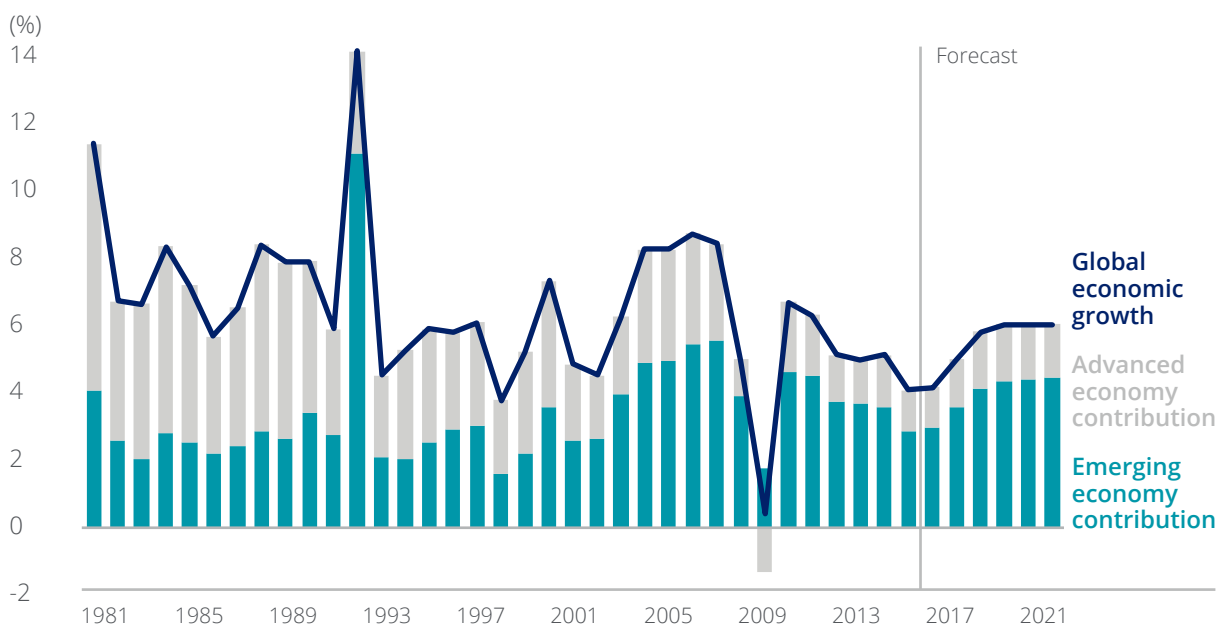


Source: World Bank; Deloitte calculations.

Note: Includes merchandise trade only. Does not include trade in services.

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Figure 4. Contribution to global economic growth, advanced and emerging economies



Source: International Monetary Fund; Deloitte calculations.

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Emerging economies have much lower trade elasticity than do the advanced economies. Figure 5 shows the persistently lower trade elasticity in emerging economies since the early 1980s. As the emerging economies' share of global activity and trade has risen, the global elasticity of trade has fallen.

Economies, firms, and policymakers in Asia should be preparing for a structurally lower trade elasticity into the future.

Moreover, the 1990s also stand out in figure 5 as being very unusual. The fall of the Berlin Wall and the corresponding raising of the Iron Curtain, along with the fragmentation of the former Soviet Union, combined to increase international trade both with and within Eastern Europe over the subsequent years.

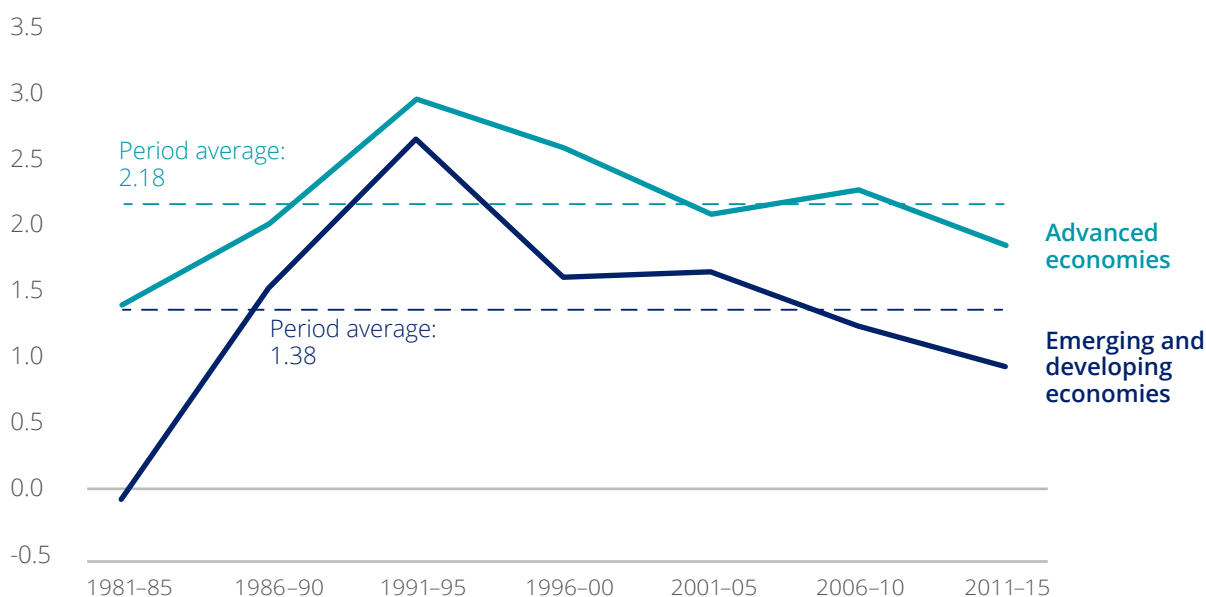
Similarly, the opening up of China to global trade, while officially beginning in the previous decade, took hold during the 1990s in terms of a big leap in trade between China and other countries (both within Asia and beyond). In addition, with advancements in technology, networking, and connectivity, the outsourcing industry centered in India started to flourish. India's trade with the United States and Europe in particular expanded

rapidly during this period. The fragmentation of global supply chains, driven by widespread falls in information and transport costs, also helped to contribute to a structural shift in trade volumes.

At the same time, trade liberalisation lowered barriers to international trade. Within Asia, the ASEAN Free Trade Area agreement was signed in 1992. In Europe, the European Economic Area was established in 1994, providing the free movement of goods, services, and capital, as well as people, within the European Union. The North American Free Trade Agreement between Canada, Mexico, and the United States took effect from 1994, while the Uruguay Round of multilateral trade negotiations—which established the World Trade Organisation—were concluded in the same year.

The 1990s was also a period when a number of countries within Asia, and some outside Asia, sought to open up their economies, including putting in place incentives for exports. This widening of the “Asian model” of economic growth—which had previously become synonymous with the economic performance of the Asian tiger economies during the 1960s and '70s—deeper into Southeast Asia helped to underpin rapid export growth in that region in particular.

Figure 5. Trade elasticity



Source: International Monetary Fund; Deloitte calculations.
Note: Trade elasticity calculated as the ratio of real import growth to real economic growth.

Trump is only the most prominent example of a new global wave of nationalistic sentiment that includes the Brexit vote in the United Kingdom and the election of politicians on populist, anti-globalisation platforms in Europe, Australia, and elsewhere.

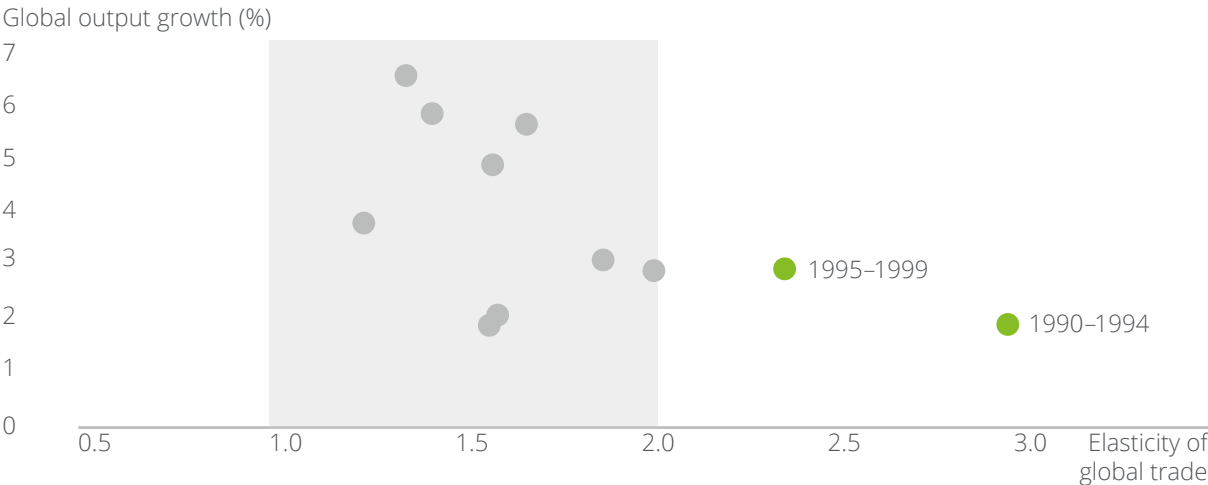
All of that suggests that global trade elasticity in the 1990s was unsustainably high.

And now there are strengthening political currents running against trade liberalisation. American voters elected Donald Trump on promises to protect US manufacturers and their workers against import competition from emerging economies. And Trump is only the most prominent example of a new global wave of nationalistic sentiment that includes the Brexit vote in the United Kingdom and the election of politicians on populist, anti-globalisation platforms in Europe, Australia, and elsewhere.

This sentiment is undercutting efforts to pursue more liberal trade policies around the world. Indeed, it threatens to reverse past gains. An example is Trump’s commitment (on “day one”) to withdraw US support for the Trans-Pacific Partnership (TPP)—a regional trade agreement covering 12 countries that account for around 40 percent of the global economy—despite it having already been signed by each of the proposed members (though it had been awaiting ratification in the United States).

Fortunately, it is possible that the remaining TPP signatories will proceed with a similar type of agreement that leaves out the United States, taking a broader scope and possibly including China.

Figure 6. Output growth and trade elasticity, 1951-2014



Source: World Trade Organisation; Deloitte calculations.
 Note: Global output growth is the average growth in production of goods in a five-year period. Elasticity of global trade is the ratio of the average growth of global export volumes of goods and of global production of goods in a five-year period.

Indeed, many are encouraged by the potential to leverage the existing Regional Comprehensive Economic Partnership negotiations—which includes ASEAN, Australia, China, Japan, India, Republic of Korea, and New Zealand—into a broader TPP-style agreement.

Moreover, trade liberalisation is only one aspect of what drives trade volumes. Other forces—including greater integration of economies, technological change, and improvements in logistics—are set to continue.

Trade has been an important contributor to Asia's rising prosperity, but the gains of the past were artificially good, and the politics of the future are problematic. Yet the outlook is better than you think.

Here's the good news: The rest of the slump is cyclical

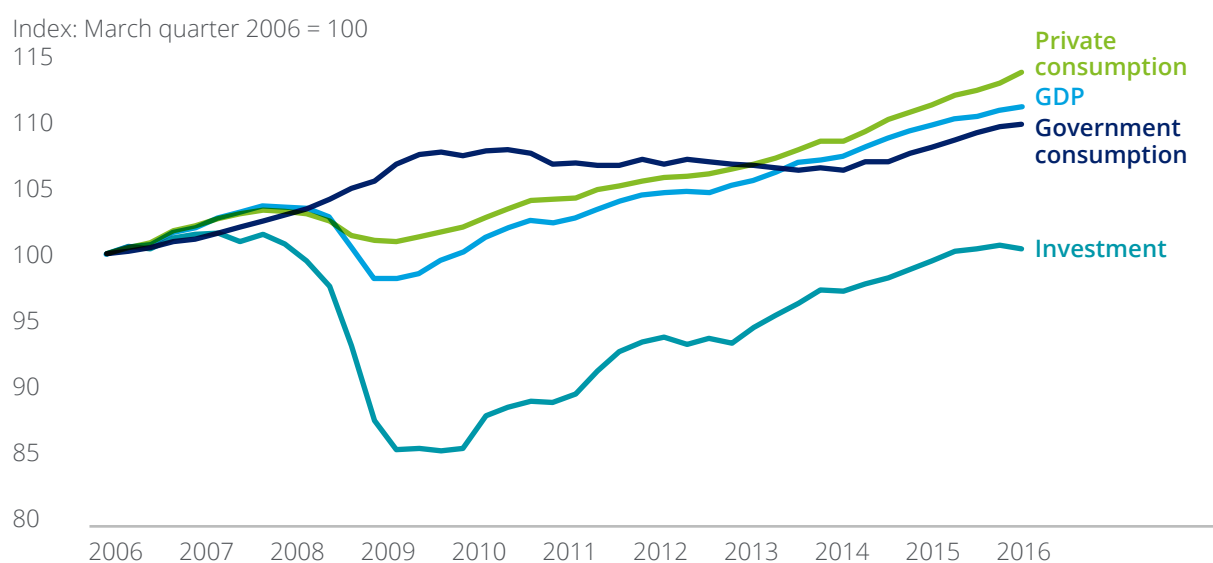
Cyclical? That means it's temporary, and indeed, the signs indicate an impending upswing. The clearest cyclical influence on trade in recent years has been the global financial crisis, which clearly had an effect on the volume of global trade activity. The impact on financial markets—including the availability of credit, borrowing costs, exchange rates, and commodity prices—added to weakness in trade.

However, most of those effects have been worked through. So why is there any lingering impact on global trade, more than eight years since the collapse of Lehman Brothers? Part of the answer to that question lies in figure 7.

That figure shows the breakdown of spending across the seven major advanced economies known as the Group of 7 (or G7). Growth since the global financial crisis has been driven by private and public consumption—the spending by households and governments. In contrast, investment—the spending on physical capital such as roads, factories, computers, office buildings, and shopping centers, all of which improves the economy's productive capacity—remains weak. Indeed, data from the Organisation for Economic Co-operation and Development (OECD) shows that the level of investment spending across the G7 economies in 2016 was exactly the same as it was a decade ago.

That has important implications for future growth. Spending on investment—capital expenditure—is a bet on the future, and firms will invest only if they can expect an adequate return on that investment. In part, that expected rate of return is driven by an anticipation of future economic growth. Paradoxically, investment also helps to underpin stronger economic growth into the future, including by boosting productivity.

Figure 7. Components of GDP, G7 economies



Source: Organisation for Economic Co-operation and Development; Deloitte calculations.

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In turn, that means low investment today will weigh on economic growth tomorrow.

So the failure of investment to recover more quickly in G7 economies also has important implications for trade. As figure 8 shows, changes in the composition of economic growth can generate changes in the trade intensity of an economy. The post-2007 change in the composition of the G7 economies toward consumer spending and away from investment has contributed to a shift in trade intensity. As a result, the elasticity of trade across G7 economies—and, importantly, their trading partners in Asia—has dropped.

Still, there is an upside to the cyclical story about trade. We think the pace of Asian trade growth will surprise in 2017.

Three reasons Asian trade will surprise on the upside in 2017

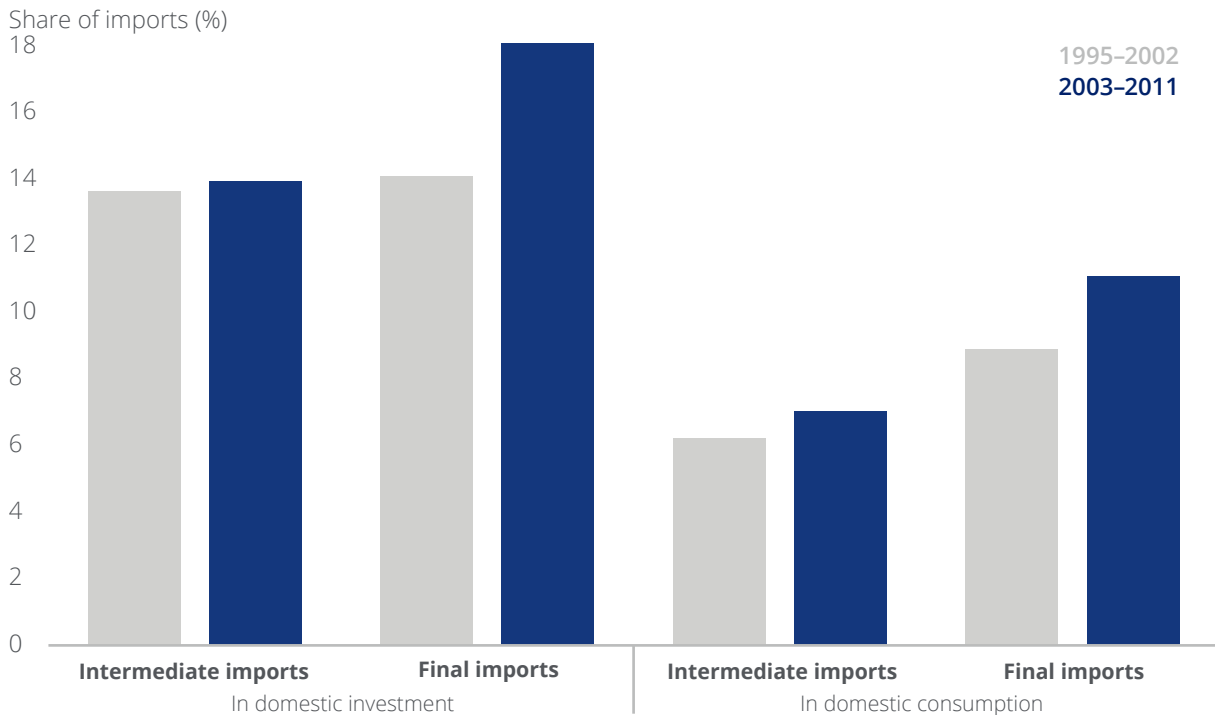
First: World trade volumes were temporarily damaged by successive crises and shocks, the effects of which are finally wearing off.

The global economy suffered an unusual sequence of shocks over the past decade. But the world economy and global businesses have adjusted to those shocks and are coming to terms with them.

With no new shocks in evidence and the damage of previous shocks wearing off, business confidence is recovering and demand is likely to normalise.

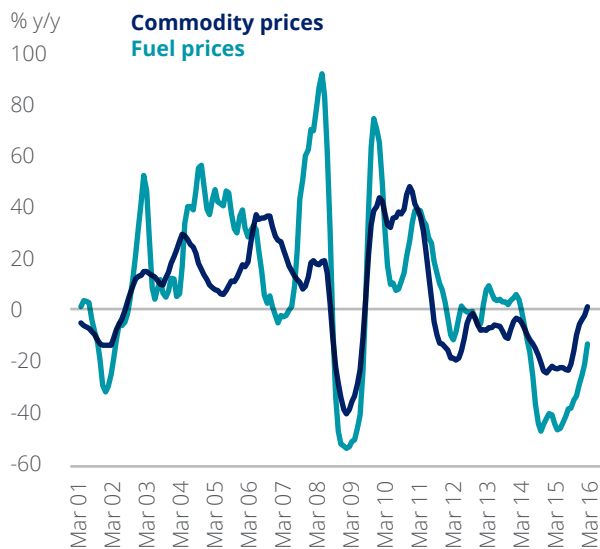
This recovery is already evident in the US economy, which is likely to grow by around 2.2 percent in 2017 despite some weakness in recent quarters, and, increasingly, in Europe.

Figure 8. Global average share of intermediate and final imports in domestic investment and consumption, 1995–2011



Source: Société Générale based on Veerendaal et al. (2015).
 Note: Data represents global average shares.

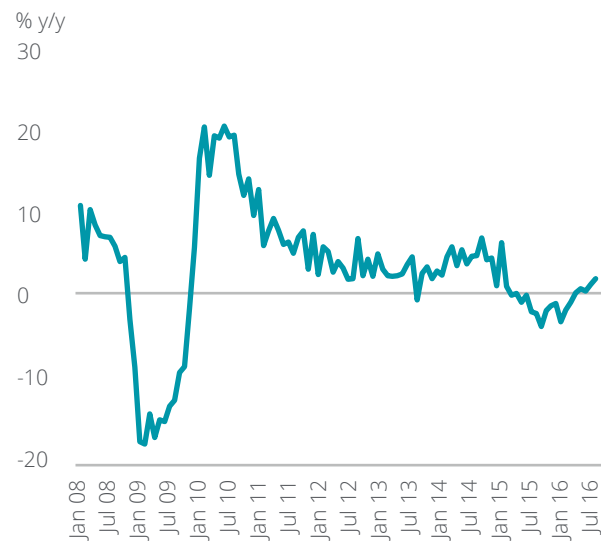
Figure 9. Price index 3MMA
Fuel and commodity prices have fallen



Source: CPB World Monitor; Institute of Shipping Economics and Logistics (ISL).

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Figure 10. Container volume growth SA
Container volumes recovering



Source: CPB World Monitor; Institute of Shipping Economics and Logistics (ISL).

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Our take is that the world economy is finally emerging from a dark period of successive major shocks, and what we are seeing is the natural healing process that occurs in economies as the worst effects of shocks wear off. This is forming a base for a more resilient recovery around the world and higher international trade volumes—so long as no new shocks materialise.

Second: Merchandise trade values have been depressed by deflationary forces, which are now easing, while leading indicators suggest volumes are ready to lift as well.

It hasn't just been trade volumes which have experienced subdued growth in recent years. Trade values (the combination of both volumes and prices) have also been depressed. That has been worsened by downward pressure on prices generally, including in relation to commodities and energy (see figure 9).

Softness in prices has been driven by a lack of demand in the global economy, evidenced by weak global growth and very subdued levels of investment. Two additional factors are also relevant when considering weak trade value growth:

- First, the strength of the US dollar has reduced the dollar price of internationally traded goods.
- Second, China has been exporting excess industrial capacity to other countries in the region, which has caused a new wave of deflationary pressures on manufactured goods prices.

Each of these factors is expected to have a diminishing impact on prices. Commodity and energy prices appear to have bottomed, and indeed, the prices of some commodities, such as coking coal, have increased sharply in recent months. The US dollar may climb further against other major currencies, but only modestly. Manufacturing capacity is expected to continue to shift from China to lower-cost producers in the region, but, in time, wage rates will rise in lower-income Asian economies as well.

The value of world trade is therefore likely to trend upward in the near to medium term, as negative price effects from the tumbling commodity and fuel prices bottom out, while leading indicators for volume growth also suggest a bump in trade volumes is looming.

At the same time, trade volumes will rise again. New export orders are climbing around the world, though the expansion is somewhat patchy:

- Taiwan, a major exporting nation, is enjoying a firm recovery, with export orders rising sharply in recent months.
- If not for labour strikes in Korea, a global export powerhouse, new export orders would probably have been much stronger there too.
- The latest indicators of export demand and import orders in China also suggest improvement following a poor 2016. Indeed, weakness in China's trade growth over the last 12 months has undermined trade growth in Asia more generally, but there are genuine signs of a turnaround.
- Electronics components demand, another leading indicator of trade volumes, is also rising. A slew of measures for demand in the tech sector—semiconductor sales, book-to-bill ratios for semiconductor equipment manufacturers, and US orders for electronic components—are all rising, some at the fastest rate since 2013, powered by booming consumer interest in new products such as wearable technology and larger-screened cellular devices.
- Sea cargo and air freight volumes are another leading indicator of trade that is rebounding. Container volumes have been climbing steadily since mid-2016 (see figure 11), while growth in air freight volumes is on the rise.

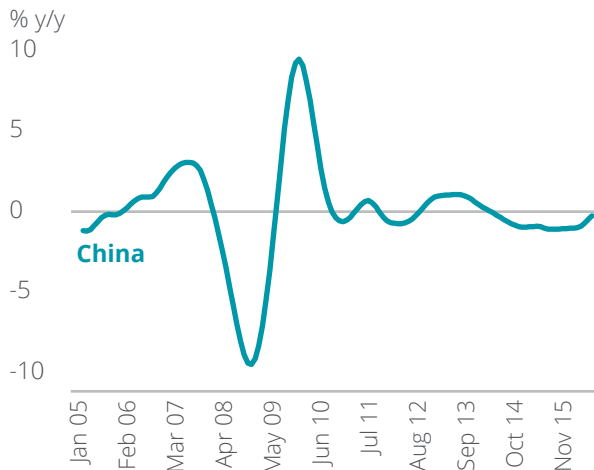
That's good news. The value of world trade is therefore likely to trend upward in the near to medium term, as negative price effects from the tumbling commodity and fuel prices bottom out, while leading indicators for volume growth also suggest a bump in trade volumes is looming.

Third: China's cyclical recovery will aid global trade, but structural changes will continue to exert a drag.

China has seen growth moderating from double-digit figures to relatively placid sub-8 percent growth in recent years. The softening trajectory of China's economy can be attributed to a difficult but necessary transition from an investment-fueled, export-led, and manufacturing-based economy to one that is more reliant on services and consumer spending. Furthermore, the build-up of debt, particularly in the corporate sector, continues to weigh on business sentiment.

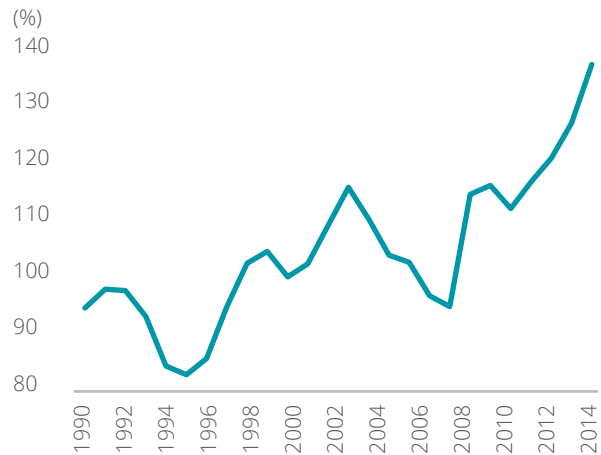
However, policymakers have shown a willingness to unleash large-scale stimulus measures in a bid to inject growth impetus into the economy, including massive monetary easing and concerted fiscal spending. As a result, economic growth has held up relatively well, even though private investment levels continue to trend downward steadily. This greater vigor in aggregate demand will in turn feed into regional trade and production networks (of which China is a key node), thereby boosting trade volumes across Asia.

Figure 11. OECD CLI
Leading indicators are turning up...



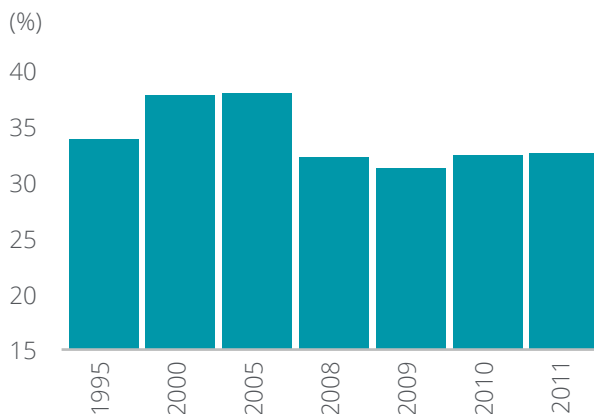
Source: CEIC database.
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Figure 12. CN: Loans/GDP ratio
...aided by massive stimulus



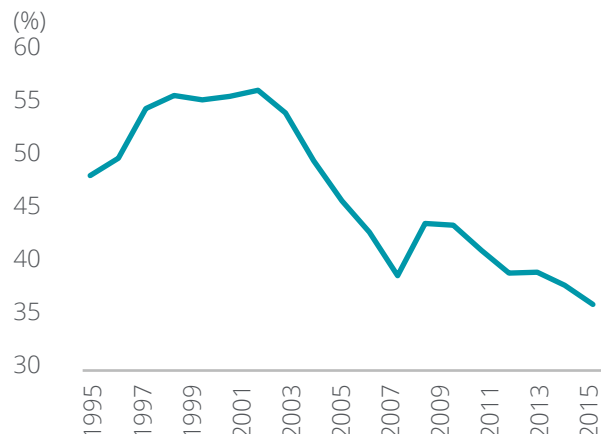
Source: CEIC database.
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Figure 13. China's foreign value added share of gross exports
Dependence on FVA has fallen



Source: OECD TIVA database; Deloitte calculations from UN Comtrade database.
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Figure 14. Imports of components as a share of exports
More value is being created within China



Source: OECD TIVA database; Deloitte calculations from UN Comtrade database.
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But structural changes also mean the Asian trade environment is increasingly reliant on China. We use the concept of global value chains (GVCs) to analyse China's influence on economic activity in the region, as it provides a good measure of trade's actual impact on an economy. This value-added-to-trade approach measures value creation

at different stages of the production process and identifies those who capture that value. This is a superior approach because it is now clear that it is intangible activities such as research and development or marketing that command higher value, while low-cost manufacturing adds the least value.

GVCs optimise the entire production process but are also a double-edged sword as imports are fed into exports of another country. As value chain concentration builds in China, the country's dependence on foreign value added in Chinese exports has decreased: More value is being created within the country (see figures 13 and 14).

Asia is increasingly plugged into China-centric value chains. Related to that, we find that, across Asia, domestic value added in exports has fallen away over time. Table 1 shows the actual dependence of major Asian economies on China for trade value creation.

This table shows that, should there be a major contraction in Chinese trade, the main losers will be Taiwan, Korea, Japan, and the Philippines. In contrast, India has relatively modest dependence on China for trade value creation. These structural

trends in intra-Asian trade are a potential vulnerability: They present a growing risk to Asian prosperity should further global (or Chinese) shocks occur.

Many see other structural challenges, most notably the rise of nationalistic politicians and the potential for more liberal trade policies to be unwound. The first few months of the Trump presidency are expected to reveal the extent to which these concerns are justified.

In general, however, there are offsetting factors at play. At the same time that dependency on China for Asian trade has expanded, manufacturing capacity has been shifting to other countries in the region. Given the broader transition under way in China—from investment-led growth to consumer- and services-led growth—this shift in capacity is important.

Table 1. Country dependence on China for trade value creation

(%)	1995	2000	2005	2008	2009	2010	2011
Taiwan	5.28	7.63	19.47	20.93	20.06	20.56	19.91
Korea	3.64	6.22	14.36	13.84	14.25	14.95	14.44
Japan	2.48	4.55	9.92	10.98	11.39	11.74	12.22
Philippines	0.82	2.32	11.65	14.99	13.30	12.43	11.61
Hong Kong	5.55	7.08	8.99	9.27	9.60	10.16	9.96
Malaysia	1.38	3.21	7.11	7.98	8.86	9.96	9.94
Australia	1.65	2.72	5.72	7.26	6.95	8.43	8.96
Singapore	1.34	2.78	6.61	6.15	5.99	7.10	7.30
Thailand	1.22	2.73	5.55	5.98	6.52	7.06	6.88
Indonesia	1.66	3.27	5.04	5.10	5.26	5.94	6.55
Vietnam	1.23	3.09	4.81	3.98	4.17	4.88	5.39
India	0.55	1.41	3.37	3.30	3.25	3.69	3.69
New Zealand	1.00	2.14	2.64	2.89	3.31	3.82	3.63

Source: OECD database.

Note: This data represents the value a country adds to Chinese exports as a proportion of value that country adds to its own exports. This helps illustrate a country's dependence on China for its trade value creation. A higher number means greater dependence on China.

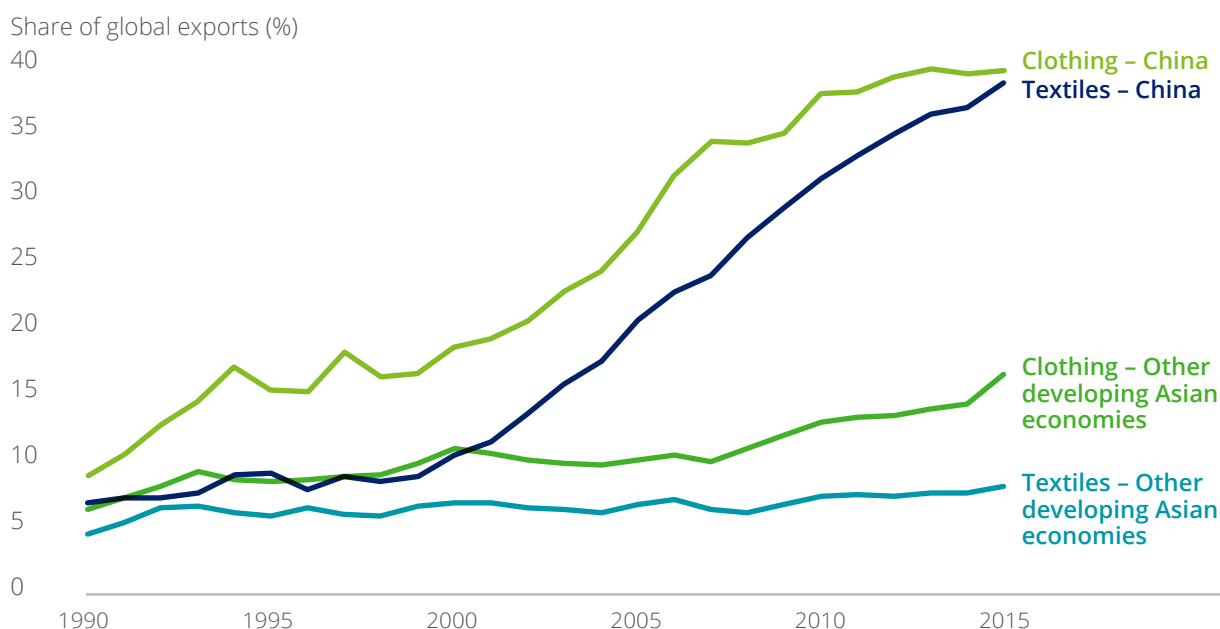
However, it is happening more slowly than many realise. Figure 15 shows that China has continued to increase its share of global clothing and textiles exports in recent years, despite evidence that manufacturers are already voting with their feet and shifting production sites away from higher-cost regions of China, such as the Pearl River Delta near Hong Kong.

One estimate suggests that the number of factories owned by Hong Kong companies in the Pearl River delta fell by around 33 percent between 2006 and 2013,² while a recent survey shows that just over one-third of the manufacturers in the region plan to shift production capacity to cheaper locations within China or to other countries in Southeast Asia, Bangladesh, India, or Sri Lanka.³ Much of the manufacturing capacity moving away from higher-cost regions of China, however, is simply moving to lower-cost regions within the country, not least because of government incentives.

That said, the widening cost differential and growing sophistication likely means that these incentives are simply delaying the inevitable. Indeed, Deloitte's 2016 Global Manufacturing Competitiveness Index noted that, by 2020, Malaysia, Indonesia, Thailand, India, and Vietnam are all expected to rank among the top 15 countries in terms of manufacturing competitiveness. These countries are already featuring in the minds of global executives seeking an alternative to China.

The timing and extent of a shift in manufacturing to emerging Asian countries outside China will depend not only on relative labour costs but on the degree to which China continues to seek to encourage relocation of factories within its borders (rather than within Asia) and the pace with which alternative countries establish the infrastructure and regulatory requirements needed to support an expansion of the manufacturing industry. Manufacturing labour costs in these five Southeast

Figure 15. Share of global clothing and textiles exports, China and other developing Asian economies



Source: World Trade Organisation; Deloitte calculations.
Notes: Data is measured as a share of the value of global exports measured in constant USD terms. The following countries are included in "other developing Asian economies": Bangladesh, Indonesia, Malaysia, Mongolia, Nepal, Pakistan, the Philippines, Laos, and Vietnam.

Asian economies (Malaysia, Indonesia, Thailand, India, and Vietnam) are already well below costs seen in China. For example, manufacturing labour costs in Indonesia are currently around one-fifth of the level in China, while costs in Vietnam and India are approximately half the level in China.

There are also longer-term competitive advantages that Southeast Asia has over China. For example, over the next 30 years, the working-age population in the ASEAN region is projected to expand by almost 85 million people. Over the same period, China’s working-age population is projected to shrink by more than double that amount (around 175 million people).

It therefore seems likely that other Asian economies are ready and able to fill at least part of the gap that China’s rebalancing toward consumption and services means for trade. This appears particularly true because the pace of relative decline in manufacturing in China is slower than it is broadly understood to be, while the longer-term labour force dynamics in Southeast Asia are favourable.

Will services trade surprise as well?

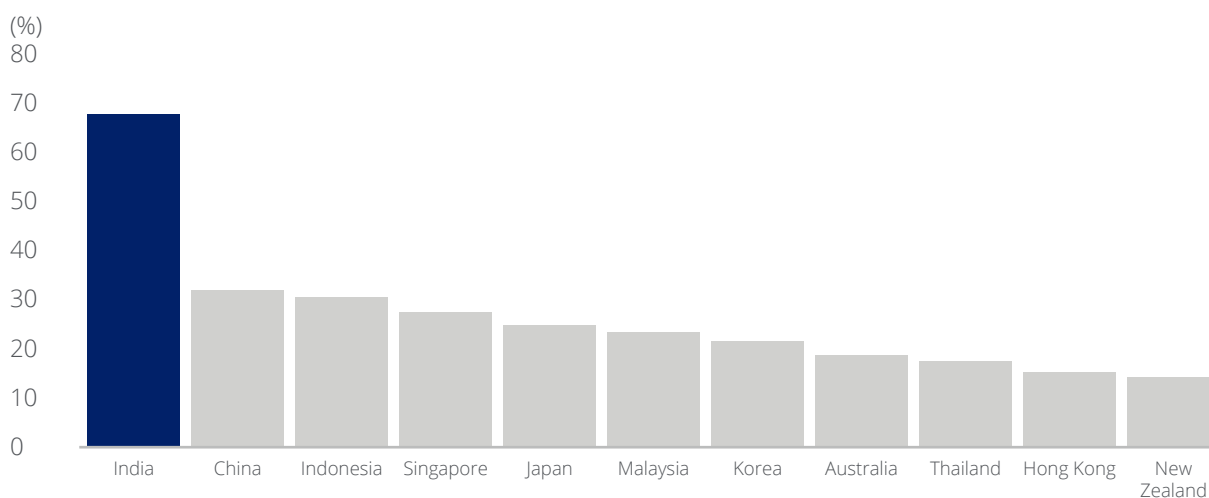
The structural strength in the demand for services is accepted wisdom in economics—over time, a rising share of global incomes are being spent on services. That has benefited countries, such as India in particular, that have prioritised

services rather than manufacturing as a platform for economic development, while services trade is also far more likely to escape any effects of populist protectionism in the coming years.

Although the gains in services will be a story for the ages, it has long been evident in the trade data. Rapid growth in services has meant big strides in exports of services too. This has been possible in the last decade due to the information and communication technology revolution of mid-1990s and a boost to growth in technology, transportability, and tradability that have in turn changed the nature and tradability of services.

Furthermore, exports in services have kept pace with changing global dynamics and a shift toward more technology adoption in all areas of the global economy, including business and professional services. This has underpinned service exports in a number of major Asian economies. For example, India’s major service export is computer services, followed by business services and then technical and trade-related services. India’s IT exports have more than doubled over the last six years, and exports now account for more than two-thirds of total revenue for the Indian IT sector.⁴ As figure 16 below shows, ICT services exports also account for around two-thirds of total services exports from India, a far higher share than most other Asian economies. It is no surprise, then, that Indian service exports are more sophisticated than the average level seen across high-income countries.⁵

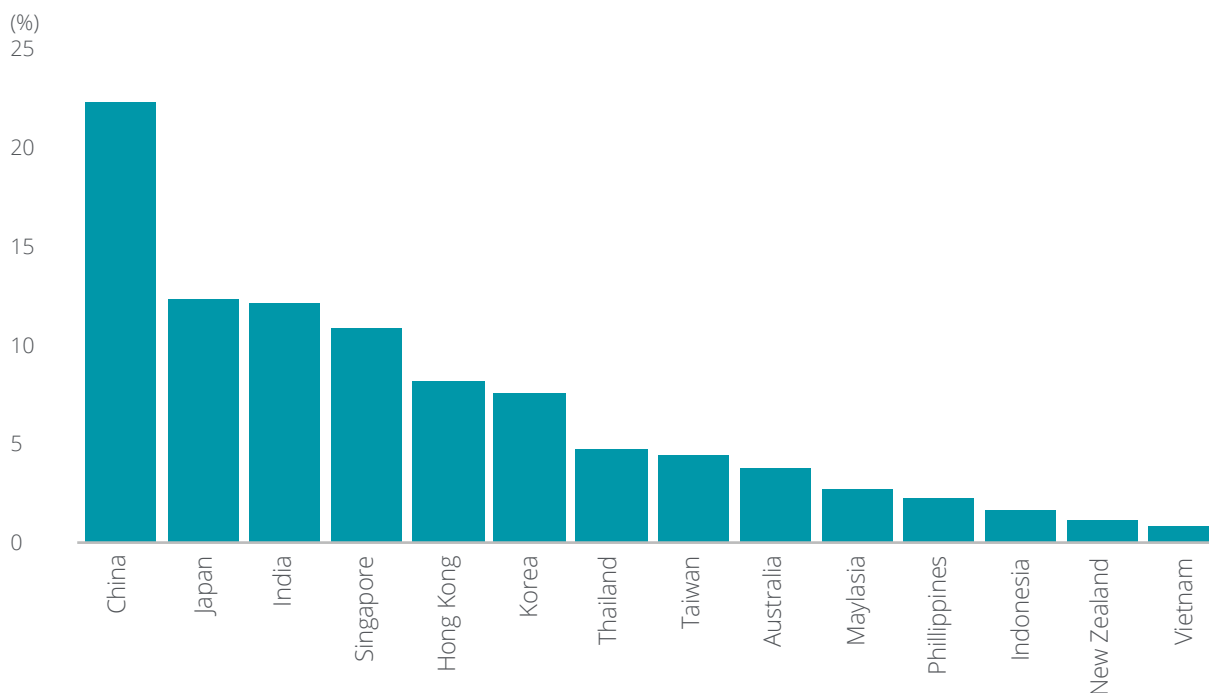
Figure 16. ICT services exports as a share of total services exports, selected economies, 2014



Source: World Bank.

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Figure 17. Share of Asia's commercial services exports, selected economies, 2015



Source: World Trade Organisation; Deloitte calculations.

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These technological advancements have also had a broader impact on services exports, with rapid growth being facilitated by the fact that many of these services do not require face-to-face interaction and have the potential of being stored and traded digitally.

In fact, over the 12 years to 2013, global commercial services exports grew at an average annual rate of 10 percent, with India helping to lead the way with average growth of 20.1 percent, followed by China at 16.5 percent. As a result, India is now the world's eighth-largest services exporter and the third-largest in Asia (see figure 17).

The most recent performance of the services sector has been more circumspect in light of the subdued growth in developed economies. There has been moderation in the rate of growth of some important services while others, such as computer services, have improved. This performance is expected to improve in the coming years as developed economies record more robust growth.

There are further reasons to be upbeat on services trade in the medium term. The rising share of services within trade flows overall means that there has been a growing focus on services within free trade agreement (FTA) negotiations. India again provides a clear example, with the country making significant progress on signing comprehensive bilateral trade agreements that cover services, including with South Korea, Japan, Malaysia and Singapore. Further, India's FTA with ASEAN came into effect in mid-2015, while the wider Regional Economic Comprehensive Partnership includes India, along with the 10 ASEAN countries and the remaining FTA partners: Australia, China, Japan, South Korea, and New Zealand.

Overall, the growing influence of services trade globally will have an increasingly positive effect on Asian trade into the future.

Longer-term tailwinds

So we can point to short-term positives. But there are longer-term tailwinds of importance as well. Two stand out:

- The rising Asian economic giants have been shifting their trade policies toward greater openness and global engagement. Their rising will underpin further trade gains through Asia and the world in the decades ahead.
- The global swing away from goods and toward services is increasingly evident in trade trends too. The gains from trade in services remain substantial.

What's next?

Cyclical and structural factors have caused trade expansion to underperform global growth in recent years. That has created a degree of pessimism about the future of trade, and those fears have been further stoked by the election of an avowedly protectionist US president.

But these fears have been overstated. Although some of the bad news on trade is here to stay, much of it has been due to factors that are now fading:

- World trade volumes were temporarily damaged by successive crises and shocks, the effects of which are finally wearing off. Trade values have been depressed by deflationary forces that are now easing, while leading indicators suggest volumes are ready to lift as well.
- A boost in the advanced economies is also likely to benefit trade in services.
- Finally, China's recovery will aid global trade.

All this will help reinvigorate trade growth in 2017, which will be a clear positive for Asia.

And there are longer-term gains on the trade menu as well, with the rise of India and the rise of services likely to prove a dynamic duo for trade prospects in the years to come.

1. Deloitte calculations using data from the World Trade Organisation
2. See Mark Magnier, "How China is changing its manufacturing strategy," *Wall Street Journal*, June 7, 2016, www.wsj.com/articles/how-china-is-changing-its-manufacturing-strategy-1465351382
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Overall, the growing influence of services trade globally will have an increasingly positive effect on Asian trade into the future.



Asia's weapons of mass consumption

A SIA'S major export markets, led by the United States, will boost this region's growth in 2017. But Asia's mega economies, China and India, have another line of defence: their cashed-up consumers.

That's because, increasingly, consumer booms are powering Asia's growth. A new, optimistic generation is taking its place in driving the direction of their economies: one that is technologically savvy, comfortable with the borderless consumerism of the global middle class, and yet imbued with the consumption-smoothing instincts of its parents and grandparents.

These new consumers are exactly what Asia and the world need. They're inherently optimistic and incredibly open to innovation. They'll make enthusiastic importers as well as formidably competitive exporters. And yet, like consumers everywhere, they will be a stabilizing force in their giant economies. That means they're likely to play an anchor role for Asia's prospects in 2017 almost regardless of other developments.

What more could Asia or the global economy ask for?

Increasingly, consumer booms are powering Asia's growth.

Asia's consumer is already a kingmaker

Two factors are sustaining China's growth:

- Investment spending, primarily by state-owned enterprises
- Strong consumer spending, supported by the strength of the property market.

Yet whereas the first growth driver may not prove sustainable, the second will: Strong consumers are here to stay. Indeed, that is a central aim of China's policymakers, who are aware that their economy is underweight consumers, and who want consumer spending to take over from construction as the key growth driver of the future.

At the same time, India has emerged as the world's fastest-growing mega-economy and has made strides in the face of headwinds of weak global growth and financial market volatility. The Indian economy, traditionally been powered by consumers, is set for another structural boost. Indeed, consumption is expected to continue its driving role in 2017 because of three fundamental factors:

- Rising wages (including for the public sector)
- A boost to rural incomes and, more importantly,
- A structural push from taxation reform.

Recent wage reforms have boosted the incomes of an aspirational population. However, it is the third factor that is expected to have the greatest impact. A major push to taxation reforms such as the rollout of a goods and services tax (GST) will improve consumer demand in the long run.

An Indian economy driven by domestic consumption is relatively sheltered from global disturbances

Over the past decade, India’s consumers have helped to underpin an enviable growth rate for their country. India has the world’s largest population of millennials, with the typical Indian consumer being young, aspirational, technologically proficient and enjoying the benefits of a fast-growing consumer market.

After experiencing the success of the first decade of the current century, many of India’s millennials share an exuberance and a belief that good education and hard work can lead to a change in fortunes. The unshackling of consumer spending has also triggered a change in mind-set from a few decades ago, with higher spending no longer necessarily regarded as wasteful behaviour.

Even so, consumer spending as a share of the economy has been declining in India over recent decades, with India’s consumers now making up close to 60 percent of all spending in the economy. That is still relatively high for an emerging economy, with China’s consumption share less than 40 percent and Malaysia’s share just more than 50 percent. In comparison, the consumption share in Japan and the United States are 61 percent and 68 percent, respectively.

China’s consumers are gaining ground as the economy moves toward consumption-led growth

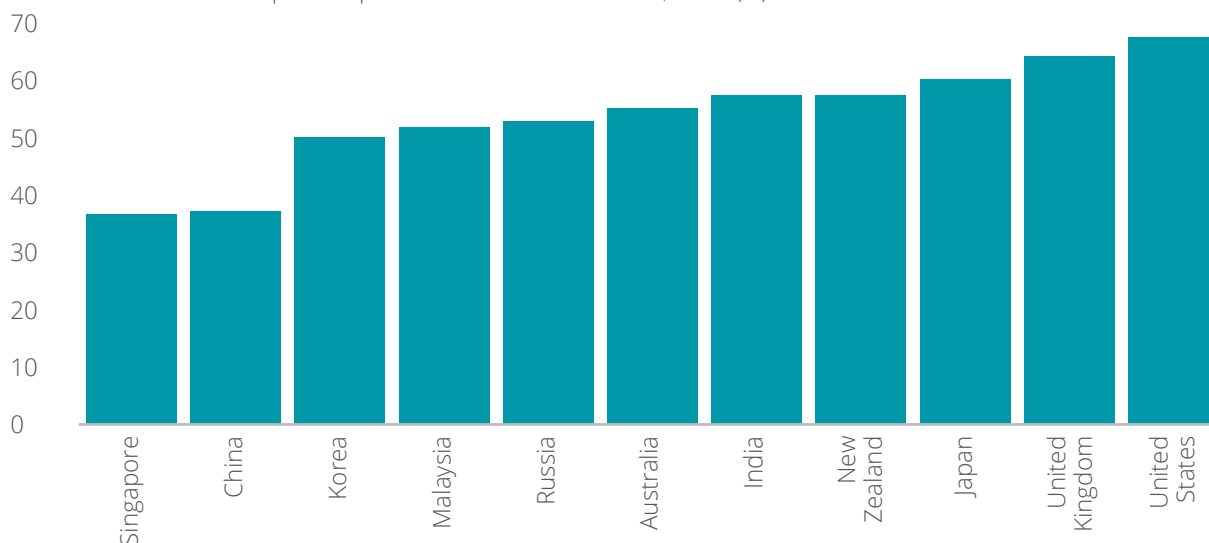
China’s economy has been slowing since the turn of the decade, but its consumers are still sprinting, with retail sales regularly clocking up double-digit gains in turnover.

There are many reasons for this resilience in retail amid a wider economic slowdown in China, but the first and most obvious are demographic:

- Those Chinese aged over 70 are big savers, and they have been all their lives. Prior to economic reform, salaries in Chinese cities had remained almost the same for nearly 30 years, and the habit of frugality became deeply ingrained.
- The story is only slightly different for those who are middle-aged. Their savings rates are also high, but they spend a lot of those savings on real estate. They strongly believe in helping the next generation to achieve a better standard of living, while looking after their own parents.
- Yet the young are very different. With almost three decades of double-digit growth behind them, they’ve happily embraced credit, consumption, and debt.

Figure 1. Consumer spending shares by nation

Household final consumption expenditure as a share of GDP, 2014 (%)



Source: World Bank.

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With those different patterns through the different generations, there's a natural demographic tailwind to consumer spending in China.

However, the overall saving rate remains extremely high, at a remarkable 46 percent. That is partly to make up for the lack of an adequate social safety net—when the safety net is poor, the desire to save is stronger. Yet it is also cultural, born of a desire to provide children with a better life than their parents. This is true even in affluent Chinese societies such as Hong Kong and Taiwan.

The young, meanwhile, are optimistic about their future incomes, and that's yet another reason why they are happy to consume more.

The upshot is a combination of soaring wealth, a nascent consumption boom, and a still relatively low share of consumer spending within the wider Chinese economy. Those are all the ingredients needed for a long-lived tailwind for China's consumers—a tailwind that may well last for a generation.

These changes are already happening, and they are already important. The millennials (those born between 1980 and 1995 and accounting for a quarter of the total population) are aggressively

taking advantage of e-commerce and online retailing, with spending through those channels currently running at annual rates of close to CNY4 trillion in 2015.

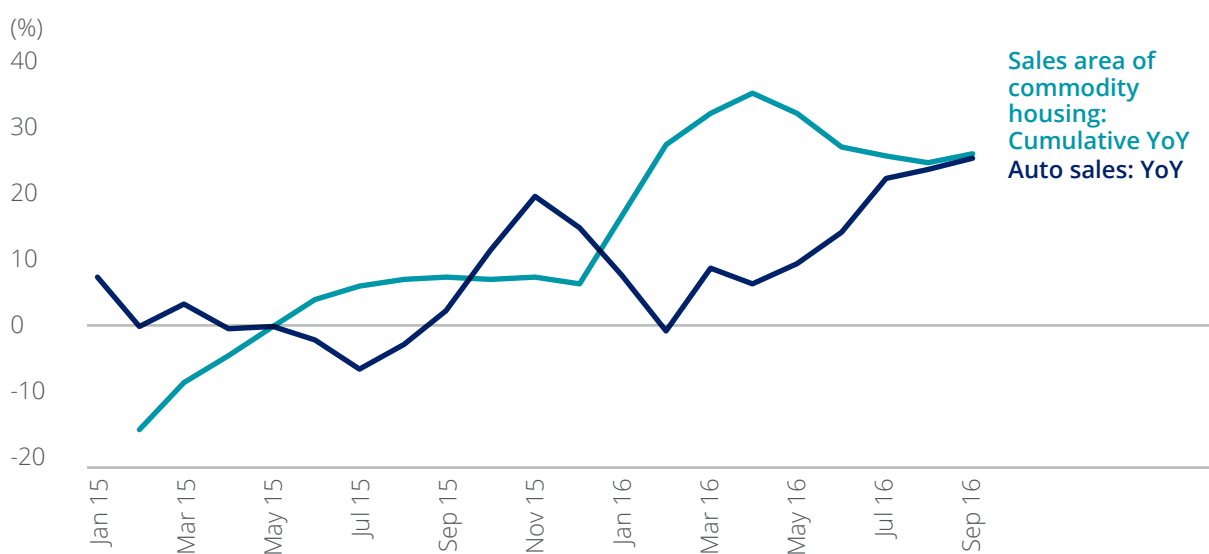
However, there also is strong demand for more time-honored forms of consumer spending. Economic history suggests that nations with per capita incomes between USD 5,000 and USD 10,000 experience an increase in demand for luxury items such as cars—and China is no exception.

Opportunities emerge for consumption growth in India

The last few years have also seen the rise of consumerism in India, with an increase in spend on durables such as electronics and automobiles, as well as on discretionary items such as travel and entertainment.

Indian households still save 22 percent of income, which shows that longer-term security goals are key but not important enough to stand in the way of India's rampant consumerism. Indian retail markets are expected to expand rapidly to 2020 and beyond, lifting from USD 600 billion in 2015 to USD 1 trillion by 2020.¹

Figure 2. Cars and apartments are the new new thing in China



Source: China Association of Automobile Manufacturers; National Bureau of Statistics of China.

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The big guns are firing up for the long haul

All the big drivers will play a role in this shift.

Strong population growth (half of all the growth in potential workforce in Asia over the next decade will occur in India). An empowered workforce with a next-generation mind-set and a high propensity to earn and spend is expected to provide a boost to India's consumption story.

Strong wage gains have resulted in more disposable income in the hands of the urban middle class (forecasters see India growing faster than China over the next decade, and some of that outperformance will show up in wages). The government recently raised public-sector wages and pensions; this is usually a once-in-a-decade exercise in which history indicates that the first areas of impact are on consumer durables and nondurables. We expect a short-term boost to consumption driven by this impact.

One must not overlook the rural economy contribution. In 2014, rural India's consumption expenditure outgrew urban India's for the first time since 1991. The National Sample Survey Organisation indicates that from 2007–08 to 2011–12, rural per capita consumption expenditure grew at 16.7 percent compared with 15.6 percent in urban areas. Fifteen major states reported faster consumption growth in rural areas, albeit with notable exceptions.

One reason for this may be the minimum support prices and the rural employment guarantee initiatives that the government had previously introduced. The schemes have resulted in higher income for farmers, translating into higher rural spending.

Last but not least, attitudinal shifts driven by changing demographics, rise of the nuclear small family, and urban aspirations have ensured a change in consumption patterns. The post economic-liberalisation generation of the 1990s faces multiple consumption choices that their parents had never seen before. Consequently, they are happier to spend than their parents, and this has become the new norm.

And there's evidence of these megatrends all around:

- Consumer confidence remains elevated, and India scored among the highest in the Nielsen Global Survey of consumer confidence.²
- India is one of Apple's fastest-growing markets.³ *The Economist* suggests that three Indians first experience the Internet every second, and that the Indian market will see more than a billion people online by 2030.⁴
- India's mobile phone subscriber base crossed the 1 billion mark in 2016, with more than 220 million smartphone users.⁵

That combination has led to the rapid expansion of online retailing, which is expected to account for 10 percent of total retail sales in 2018, up from 6.5 percent in 2013 and 3.5 percent in 2008.⁶ Amazon expects India to become its largest overseas market, surpassing industrialised nations such as Japan, Germany, and the United Kingdom.

That said, there are some immediate risks from the fallout of the government's demonetisation move in late 2016. We believe that this slowdown is temporary and that consumption growth will be back on track by mid-2017.

Attitudinal shifts driven by changing demographics, rise of the nuclear small family, and urban aspirations have ensured a change in consumption patterns.

Another shot in the arm: Tax reform

But this is not the complete story. Moving beyond the structure of the economy, there are additional positives: The Indian government has responded to the boom by increasing access for foreign investors and reforming the taxation of consumption. It now permits foreign direct investors to acquire 100 percent ownership of online retailers, while foreign portfolio investors are permitted to buy up to 49 percent with certain conditions.

However, the more crucial reform is the new GST, which is to be introduced shortly. The key idea behind this tax is to broaden the tax base and lower overall taxation rates. The way implementation is being sought in India also presents an opportunity to enhance the ease of doing business in the country with the whole system being technology-driven.

The GST is likely to have differential impacts across sectors and will possibly lead to higher prices for services and possibly stable to lower prices for goods. Overall rates are likely to come down under the new regime, as the government is intending to keep four rate slabs depending on the nature of the item being taxed. The move to a GST is likely to increase consumption demand, as lower taxation would benefit producers who in turn—driven by competition—are likely to pass on some of the gains to consumers.

We expect a supply-side boost as well. India has traditionally been a supply-constrained economy, and a boost to the supply of goods and services could bring lower inflation and increased competitiveness. This could positively affect the real income of households and boost consumption.

China treading its own path, balancing risks and opportunities

China's leaders might say that, for the present, just maintaining the present consumer share of their economy is challenging enough. In part that's because China's consumer boom is dependent on the government being able to keep sustaining the unsustainable—the over-investment, an overstretched housing market, and yawning debt—while it hurriedly builds a new, more viable consumer-driven service-based economy.

In particular, China's property boom is proving difficult to manage. Banks, wary of lending to an industrial sector plagued with overcapacity, have regarded the housing sector a safer bet. Over the past year, housing prices have appreciated sharply in all of the major Chinese cities (17 percent for the 100 biggest cities, and 27 percent for first-tier cities).

- This has led nine cities, including Beijing, Shenzhen, Nanjing, Suzhou, and Xiamen, to impose restrictions on demand for housing. These restrictions include requiring deposits of up to 70 percent and bans on purchases of second homes.
- However, housing prices in many major cities were already so high that they were nearly unaffordable and may have hit a plateau. These high property prices are among the factors behind the continued capital outflows from China.
- At the same time, the number of still-unsold dwellings is putting financial pressure on local governments in smaller cities.

The central government has been encouraging banks to lend to home buyers in order to reduce the number of unsold apartments. It also hoped that the restrictions on home purchases in the first- and second-tier cities would see liquidity redirected to smaller cities' oversupplied markets.

However, the increase in capital outflows suggests that the regulations might not work as neatly as that. If housing prices in first- and second-tier cities fall, then the most likely scenario is an even greater fall in prices in third- and fourth-tier cities. Local government finances would face severe challenges, and consumers would have to increase their savings to repair their balance sheets.

In other words, while the housing price boom has supported consumer spending in China, any unravelling of that boom could prove problematic for the consumer engine. In turn, that says the management of the exchange rate in 2017 also could have profound implications for the housing market, investment, and consumption.

As we argue in the first report in this series, further depreciation in the Chinese yuan will be desirable in 2017. If properly managed, the depreciation should, among other things, attract capital inflows to support the economy through its difficult transition.

However, the depreciation must be decisive. If the exchange rate is guided lower gradually, as was the case in 2016, more capital is likely to flow out of the country on expectations of a further decline in the exchange rate. In that situation, the use of capital controls to try to stabilise the exchange rate might only make things worse.

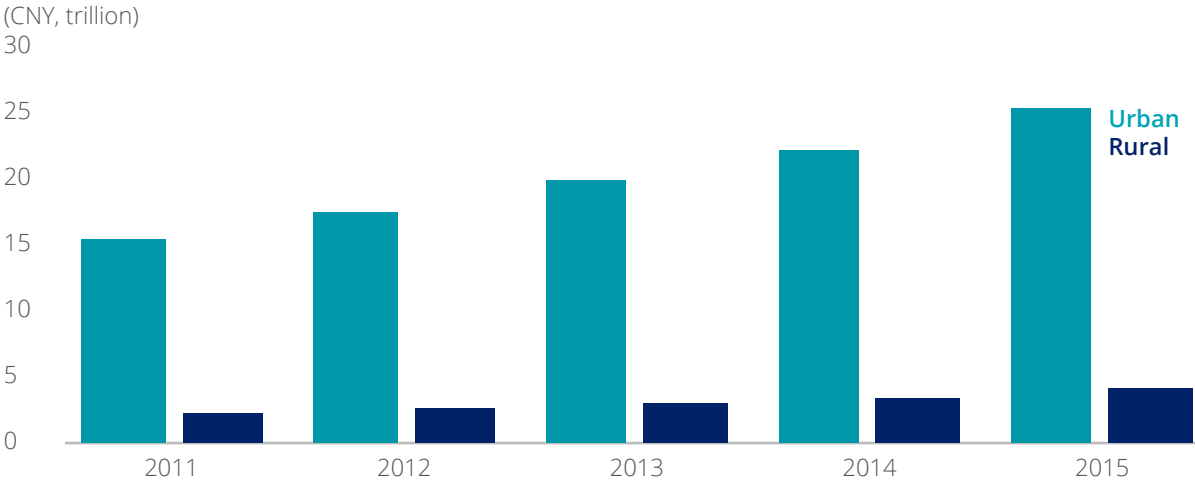
So despite the risks wrapped up in housing prices, there are short- and long-term options to boost consumer spending in China, aided by demographic tailwinds. We believe that the country's consumption boom can be sustained given the scope for further reform and the state's ability to spend. Given the right reforms, including reform of the state-owned enterprises, private investment could pick up on the back of eased restrictions and improved liquidity.

And there is more: The untapped rural consumer

In the long run, China could lift the consumer share of its economy significantly toward India's 60 percent by empowering rural consumers and improving the social safety net. If the government could spend more on education and health care, then consumers would feel more confident and reduce their "rainy day" saving.

In addition, other government reforms could boost rural consumption significantly. Half of China's population lives in the countryside, but rural consumption, which has been growing quickly in recent years, lags well behind urban consumption mainly because the Hukou system discriminates against rural migrant workers who have no access to many resources enjoyed by urban dwellers. Boosting fiscal spending on education and health care in rural areas is part of a short-term solution. And, in the medium to long term, farmers should be allowed to sell their land so that they can gain from the housing boom.

Figure 3. Chinese urban and rural retail sales are proxies for consumption



Source: National Bureau of Statistics of China.

Looking ahead: China, India, and beyond

This report points to a range of reasons for confidence in the consumer outlook—short and longer term—in both China and India.

But Asia is much more than just China and India, and the basic conclusion that consumer resilience should stand this region in good stead in 2017 holds all the more true with a wider Asian lens. Indeed, economies such as Indonesia have equally seen a rapid pace of income growth and urbanisation over the last two decades in particular. Over the 10 years to 2015, the share of Indonesia's population classified as either high-income or upper middle-income has risen from 15 percent to 60 percent, underscoring the consumption potential that the country offers into the future.⁷

Chances are, therefore, that Asia's consumers are likely to play an anchor role for this region in 2017 almost regardless of other developments.

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