

## Watching and waiting for rebound

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**Through its trade flows, the GCC is very exposed to hard-hit Japan, but also to the countries that trade with it, which should be a key concern for regional policymakers amid global retrenchment.**

Among the G7 countries, Japan has been the hardest-hit victim of the ongoing global economic turmoil.

Japan's real GDP fell by 12.1 per cent in the fourth quarter of 2008, with net exports contributing about 10 percentage points to this decline.

This is a troubling development for the GCC economies, as Japan is one of the largest importers of the region's crude oil and gas.

Barring Japan, a significant portion of the Gulf's exports go to other Asian economies, which also rely heavily on Japan. About onethird of GCC's imports come from Asia. On balance, the Gulf countries maintain a trade surplus against Asia (including Japan).

The deteriorating outlook of the world economy has directly affected the GCC economies in at least two ways.

First, there has been a collapse in global oil prices on the back of a slump in global demand (a negative 'terms-of-trade' shock), and, as a consequence, Opec's production-cut decision (reducing export volume), which thus far has had only a mixed impact. These developments have been reflected in a GCC-wide decline in the trade surplus, which is projected to be just 0.6 per cent of GDP in 2009, down from nearly 36 per cent in 2007 and 2008.

Several factors have contributed to the sharp decline in Japanese output, and undermined its future economic outlook. First, weaker overseas demand has caused a sharp fall in the exports of Japanese cars, electronic goods, information technology and capital goods. The extent of the global credit crunch and extraordinary uncertainties about the economic outlook have prompted firms and consumers to cut their investment and spending on durable goods.

Japanese automakers have been hit by poor sales in developed countries. For example, on a year-on-year basis, new motor vehicle registrations have dropped by over 30 per cent in the US and UK. As a result, Japan's car exports fell by 65 per cent since September 2008, with shipments to the US plunging almost 75 per cent. Japan's woes were further exacerbated by the strengthening of yen, by nearly 30 per cent in real effective (trade-weighted) terms since August 2008.

Economic weakness in Japan hurts GCC economies directly by lowering the latter's exports volume to the former, but there is also an indirect channel. Many East Asian economies (such as China and Korea) rely heavily on Japan as an export destination of their goods. Thus, slowdown in Japan will reduce the exports earnings of the East Asian economies which in turn will affect the GCC exports owing to the drop in income of East Asian citizens. This connection stresses the importance of Asia to the Gulf's economic growth, an issue that is often bypassed in regional policymaking. A recent Economist Intelligent Unit (EIU) report projects China as a key trading partner for the Gulf by 2020, while strong historical and cultural ties with India is also expected to boost trade in both directions.

Besides being the largest importing partner of the GCC's oil and gas, Asia seems a promising region for investing in farmlands to ensure the Gulf's future food security. The GCC is a net food importer. Across the region, aggregate spending on food imports is projected to more than double from \$24 billion (Dh88.15 billion) in 2008 to \$49 billion (Dh179.98 billion) by 2020, according to the same EIU report. Scarcity of water deters growth in agricultural production domestically. The region's largest agriculture producer, Saudi Arabia, recently announced that it will phase out its wheat production by 2016 in order to save water.

Asia's fertile farmlands thus present a good opportunity.

If trade patterns are to be taken as a driver of economic growth, certainly Asia should get more weight in regional policymaking, especially in reforming GCC's exchange rate policies. Three (China, Japan, and India) of the world's top four economies will represent Asia by 2015, and the share of GCC exports to Asia is almost universally expected to increase. Trade flows have trebled since 2000 and now stand at more than \$300 billion (about Dh1,101 billion). In addition to relying on a cheap labour supply from Asia, major Gulf sovereign wealth entities have recently increased their attention to East Asian markets, which are now regarded as more favourable and having a less politically-sensitive investment climate compared to traditionally favoured avenues in mature, Western markets.

Economic recovery in Asia is therefore crucial for the Gulf.

Fortunately, recent data are showing greater signs of economic recovery in China by this mid-year, supported by the large fiscal and monetary stimulus now being implemented. As a result, the prospects for rapid economic recovery in other East Asian countries have been elevated.

Nonetheless, a more optimistic outlook for Asian growth would require a recovery in the global economy, especially in the United States. It seems too soon to point to that, particularly in the absence of a rebound in demand from the G3 economies (US, EU and Japan) which absorb most of Asian exports. In the meantime, the Gulf economies should continue their planned counter-cyclical fiscal policy to help cushion the economic impact of the global financial crisis.

### **Case study: South Korea**

After Japan, South Korea stands as the second-largest export destination for the GCC countries. In 2007 more than 11 per cent of GCC's exports were shipped to South Korea. The impact of the global crisis on the South Korean economy has been surprisingly heavy. GDP in 2009 is projected to contract by somewhere between 4 and 10 per cent. This weakness is a reflection of a number of factors, including a high unemployment rate, falling export growth, weak consumer confidence and a tight credit market. Against this backdrop, South Korea's government unveiled a \$21 billion (about Dh77.13 billion) fiscal stimulus package (about 3.5 per cent of the country's estimated GDP for 2009) on March 24 in an effort to soften the impact of the economic downturn. A quarter of the fiscal package is meant

for supporting small- and medium-sized enterprises, which account for almost 90 per cent of the country's employment. The government also announced a number of tax cuts for individuals and tax breaks for companies in the wake of the sharply deteriorating economic outlook. Similarly, the Bank of Korea (country's central bank) is aggressively pursuing loose monetary policy, having cut its policy rate six times since October 2008, to a record low of 2 per cent. Despite these aggressive measures, economic uncertainty continues to undermine South Korea's rapid recovery. Many experts now believe that the Bank of Korea will soon be forced to adopt more unconventional policies, such as quantitative easing, whereby it simply creates money in order to buy financial assets.

### **Case study: China**

China is gradually emerging as a key trading partner of the GCC countries. In 2007 China accounted for more than 6 per cent of GCC's exports. In particular, China is the largest export partner of Oman, while Saudi Arabia has recently increased its economic integration with China by establishing petrochemical plants. Like its neighbouring East Asian countries, China has experienced a sharp fall in its export earnings. Nevertheless, two factors are helping sustain the economic momentum. First, exports account for a smaller share of the economy, particularly after factoring their high import content. Second, the government has acted aggressively to provide major fiscal stimulus in selected areas to boost the economy this year and next. That package is already provoking signs of improvement, as some private-sector estimates suggest that the economy grew by 5-7 per cent in the first quarter of 2009, a rather strong performance given the global context. Moreover, the closely watched Purchasing Managers' Index (PMI), which tracks the performance of the manufacturing sector, reached 52.4 in March 2009 (with 50 being the borderline between economic contraction and expansion). Meanwhile, the People's Bank of China has taken a number of measures to stimulate the economy: slashing interest rates and reserve requirements, and eliminating credit quotas. This resulted in a credit glut in the first quarter of 2009, wherein Chinese banks disbursed more than \$670 billion (Dh2,460 billion) in new loans, representing 20 per cent year-on-year growth. The Chinese economy is projected to expand by 6.5 per cent in 2009 and 7.5 in 2010, according to the IMF's latest World Economic Outlook (WEO).

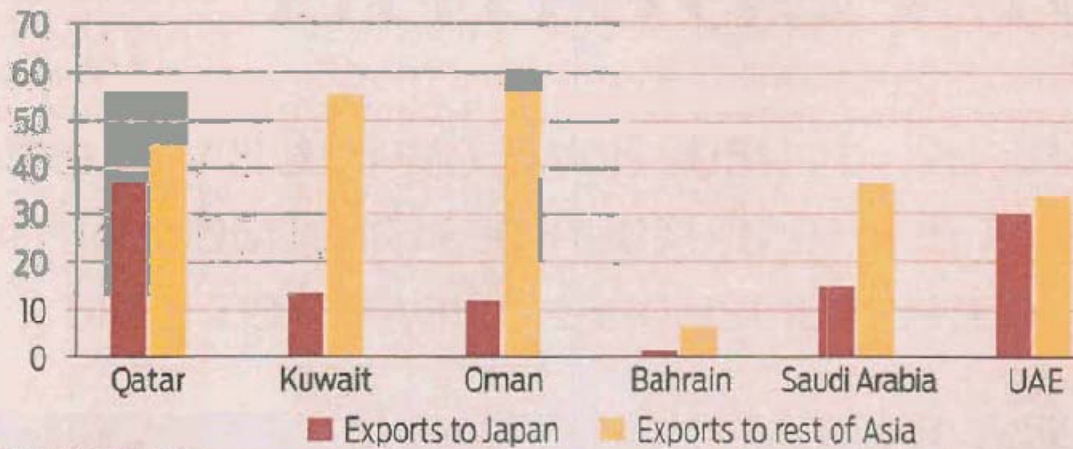
### **Case study: India**

The GCC has strong historical and cultural ties with India. Trade between the two is also increasing steadily. In 2007 India accounted for nearly 2.5 per cent of GCC exports. Moreover, the Gulf heavily depends on skilled and unskilled Indian workers who contribute greatly to domestic demand.

The Indian economy is facing major economic challenges stemming from the global financial crisis. Weakening capital flows and a depressed volume of trade are the two main channels. There has been a vigorous response in terms of boosting liquidity and loosening monetary policy. Since October 2008 the Reserve Bank of India (RBI) has lowered its policy rate by 400 basis points, and further rate cuts are likely in 2009. To boost capital inflows the RBI has taken a number of measures, including the relaxation of restrictions on external commercial borrowings, the abolition of interest-rate ceilings on borrowing, and increasing the annual limit on foreign institutional investment in rupee-denominated corporate bonds to \$15 billion (about Dh55 billion). At the same time, the government announced several fiscal-stimulus measures to spur domestic demand, which amounted to about 1.5 per cent of GDP. In December 2008 the government advanced a general 4 per cent cut in the central value-added tax rate, while borrowing limits for state governments have been increased. Like China, despite the contraction in the export sector, the Indian economy has continued to grow positively because trade is a smaller share of the economy. Nevertheless, the Indian economy is suffering from comparatively more difficult external financing for firms and banks. According to the IMF's latest WEO, growth is expected to decline sharply from more than 9 per cent in 2007 to 4.5 per cent in 2009, primarily due to weaker investment conditions.

# TRADE DEPENDENCE

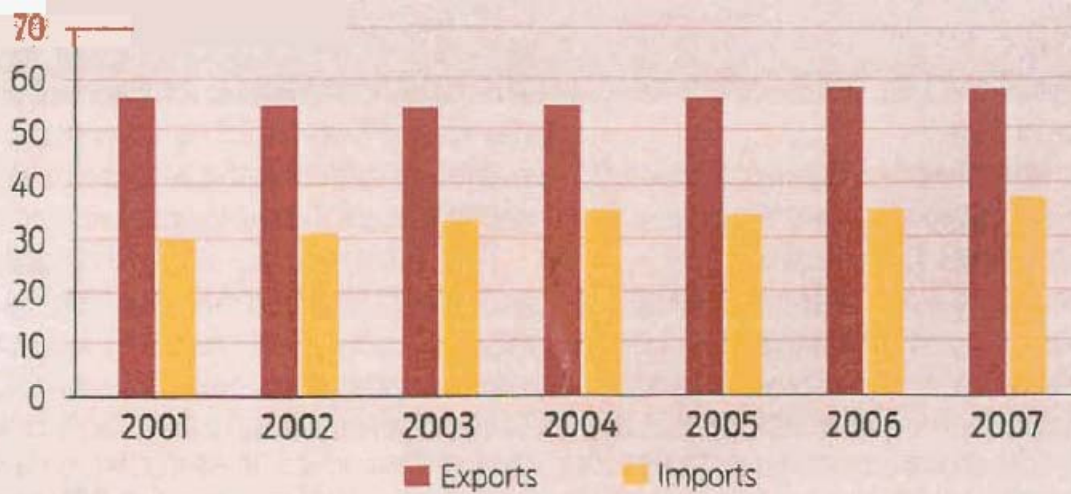
## EXPORTS, %



SOURCE: IMF (2007 DATA)

# GCC TRADE WITH ASIA

## SHARES OF TOTAL, %



SOURCE: IMF

*- The author is a research economist at Qatar Central Bank. The views expressed are the author's own.*