Developed Countries Downswing – Emerging Markets Inflation Requires Restrictive Policies

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Deutsche Bank Research

Agenda

1. The global economy - heterogeneous downswing
2. USA – strong enough to avoid a technical recession?
3. Euro area – the decoupling debate is over
4. EMs – last pillar of global growth challenged
5. Philippines – weathering the storm
6. Conclusion – damned fragile world

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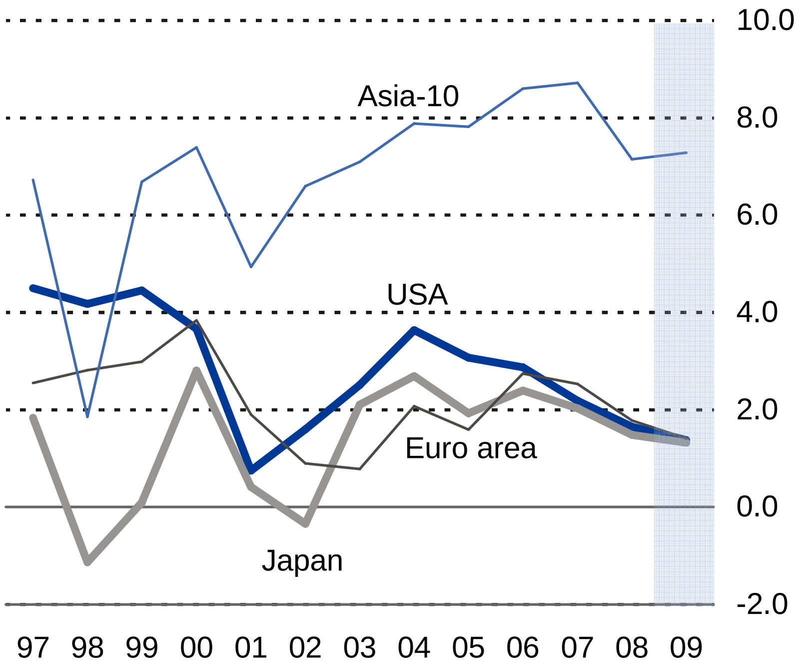
1 The Global Economy

Heterogeneous Downswing

Global economic downswing – but no technical recession

Global growth slowing

Real GDP, yoy



Source: DB Research

- Higher commodity, food prices and - - due to the high inflation rates - more restrictive monetary policy will dampen global growth.
- US economy is well below its potential due to the sub-prime crisis.
- Emerging Markets - the last pillar of global growth - challenged.

Supply grows modestly – Demand, while checked by effort to save, still on the rise

Oil price has tripled since 2005

Brent Blend, USD bbl.

Source. DB Research

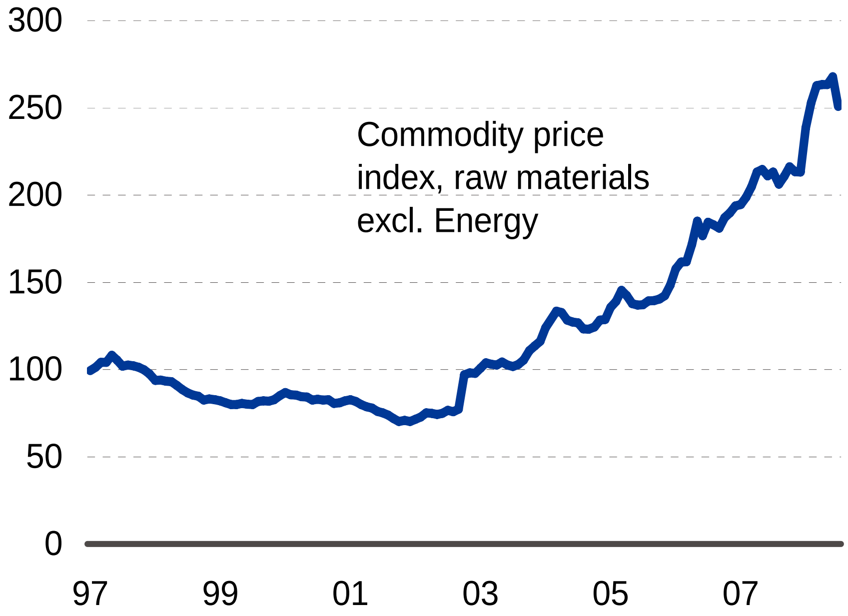
- Opposite economic impact of higher oil prices for consumer and supplier countries.
- With little spare capacity left, the market is highly vulnerable to potential terrorist attacks or renewed military action in the middle east.

Could we see a replay of the seventies?

- The hike in oil prices is due to a demand boom and not like in the seventies due to a cut in supply.
- The increasing demand is an indicator of the high economic growth rates during the last years, especially in the emerging markets.
- The global economy is less vulnerable to oil price hikes compared to the seventies – due to:
  - Higher absorption of the Oil exporting countries (“Petrodollar-Recycling”)
  - Higher Energy efficiency
  - Share of oil in global trade has decreased significantly since the seventies
- But oil is still the most important single product in the world – it still has a high impact on the economic development.

Not only oil is expensive

Commodity price index
Index 1990=100

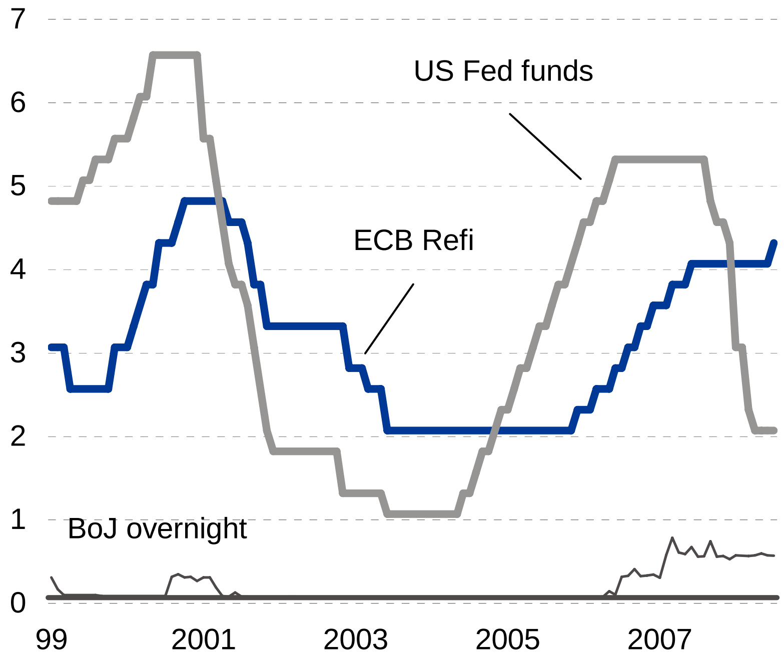


Sources: HWWI, DB Research

- Rising demand from Emerging Markets is not limited to energy related raw materials.
- Nearly all kinds of raw materials are effected by an increasing demand.
- While supply is - at least in the short run - rather inelastic.
- Since 2003 most commodity indices doubled.

Divergence of monetary policy – “ice or fire”

Central bank interest rates
in %

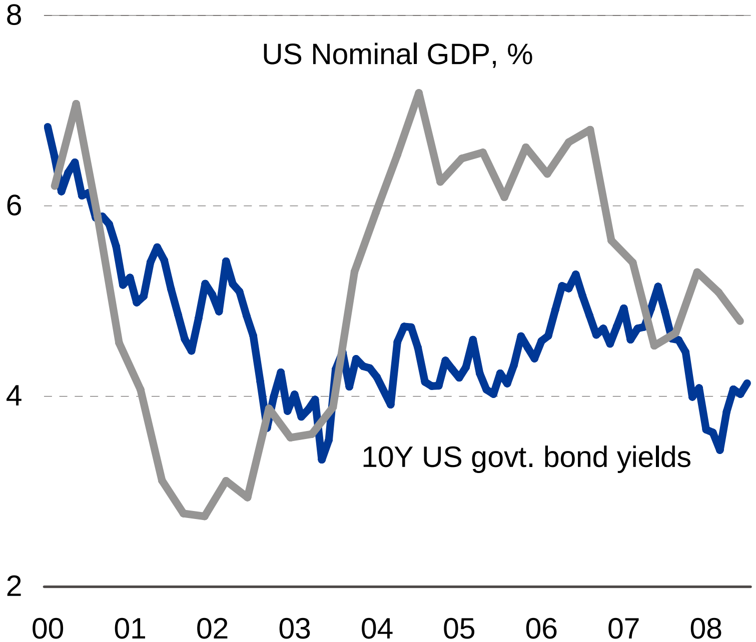


Source: Deutsche Bank Research

- FED: 2%
- ECB: 4,25%
- Permissive monetary policy in most emerging markets.

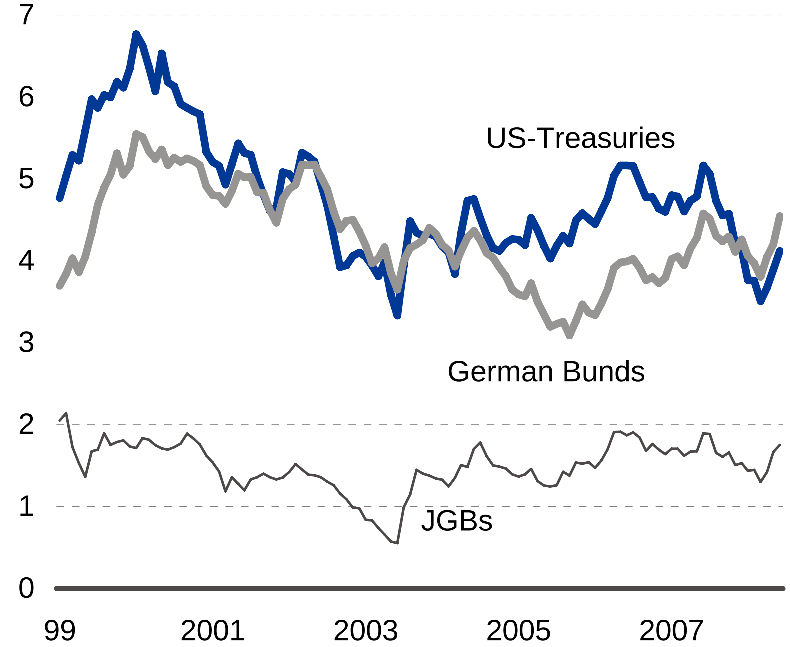
Interest Rate Conundrum – not yet resolved

Bond yield still not in line with fundamentals



Sources: Federal Reserve, DB Research

US-DE yield gap narrowed -
but still not reflecting inflation differentials



Source: Deutsche Bank Research

Stagflation established?

- **Inflation rates are well above the target rate all over the world.**
- **This raises the probability of a Stagflation scenario.**
- **Will the FED and some Asian central banks raise interest rates?**

2

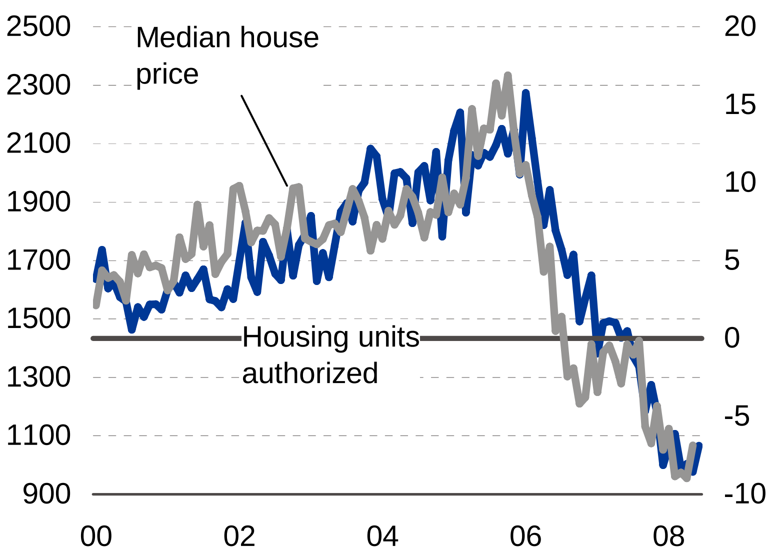
The US Economy

Strong enough to avoid a technical recession?

Sub-prime crisis has been the trigger for the sharp US slowdown

Housing market reversed

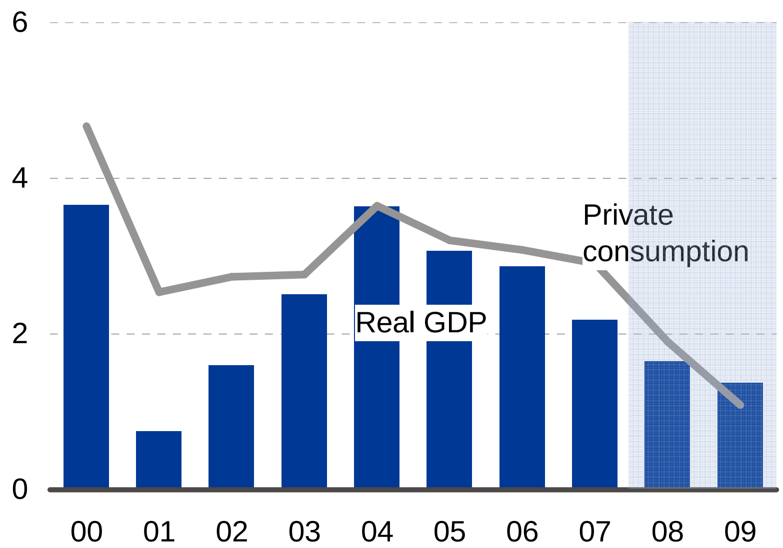
Housing units auth., 1000 annual rate (left)
Median house price, % yoy (right)



Source: Census

-dampens consumption and GDP

% yoy

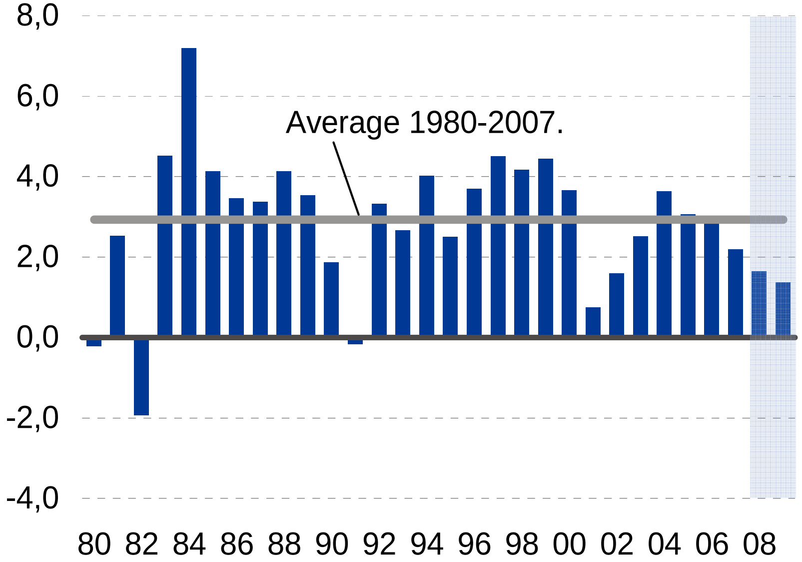


Sources: BEA, DB Research

Far below potential but no technical recession

US growth below trend

Real GDP, % yoy

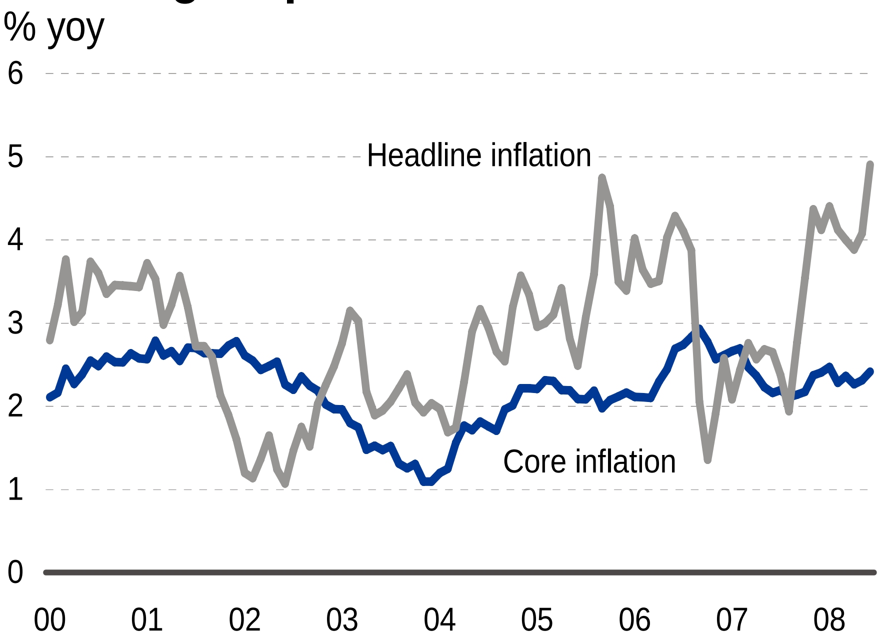


Source: BEA

- It seems that monetary/fiscal activities should prevent the economy from falling into technical recession:
  - Fiscal stimulus package
  - Massive cut in the Fed Funds rate
  - And as a consequence the depreciation of the dollar
- Financial crisis, expensive commodity imports, high current account and budget deficit remain drags on the US-economy.

Inflation too high for too long

Will an increasing output gap and de-creasing oil prices reduce inflation?

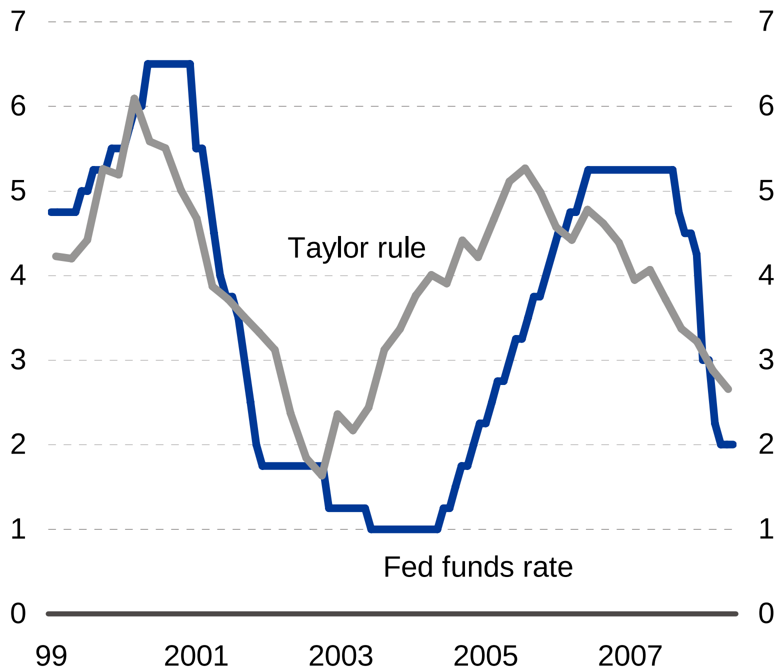


Sources: BLS, DB Reserach

- Headline inflation is more than twice as high as the target rate.
- With pressure still in the pipeline and too permissive monetary policy, high headline inflation is lasting for a while.
- Conflict for the FED – priority for growth versus fighting rising inflation.

USA: Fed Funds rate too low?

Fed funds rate & Taylor rule
in %



Source: Deutsche Bank Research

- The gain of bailing out homeowners and financial institutions has to be weighted against the long-run cost of re-anchoring inflation expectations later on.
- Thus, even with a weak economy in mind the FED is - due to the persistence of high inflation - forced to raise interest rates.
- Or: Is the FED playing with its credibility?

A U-shaped economy in the US

- **Should the USD depreciate further, inflationary pressures in the United States would increase.**

- **A cocktail of a weak economy, necessary monetary tightening and further write downs of financial institutions makes for a wide open**  **- shape.**

3

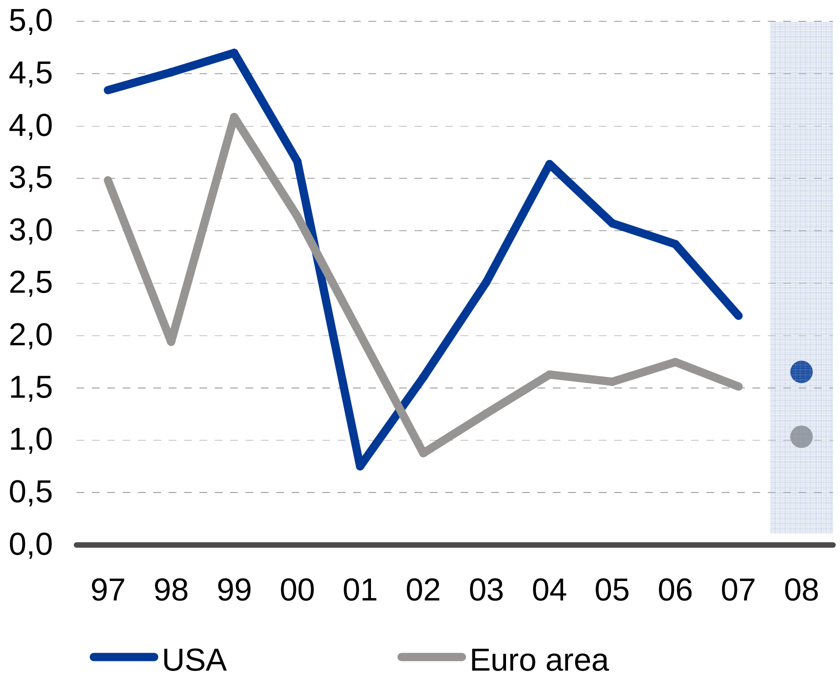
The Euro Economy

The decoupling debate is over

Decoupling – again proves to be a red herring

Sluggish economic growth

% yoy



Sources: Eurostat, DB Research

- Recession in several European economies is possible due to real estate and construction crises.
- Long-term growth potential of the Euro economy is low due to the demographic challenge.

Exchange rate of the Euro poses a burden on exports

Exchange rate USD/EUR

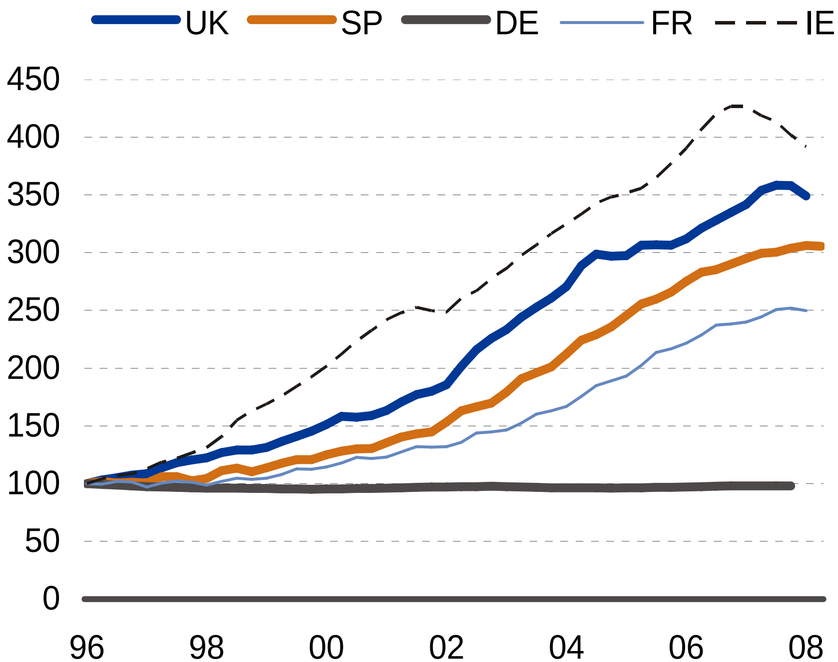
Source: ECB

- The massive appreciation of the Euro against the USD decreases the competitiveness of the Euro-area.
- Export-oriented companies suffer heavily from the current exchange rate which is well above the calculated equilibrium exchange rate.
- The export losses are only partly substituted by the increasing demand from the oil exporting countries.
- The positive exchange-rate effect of more purchasing power has been taken away by the high energy and food prices.

Real estate sector causing recessions in several European countries

House prices in Europe

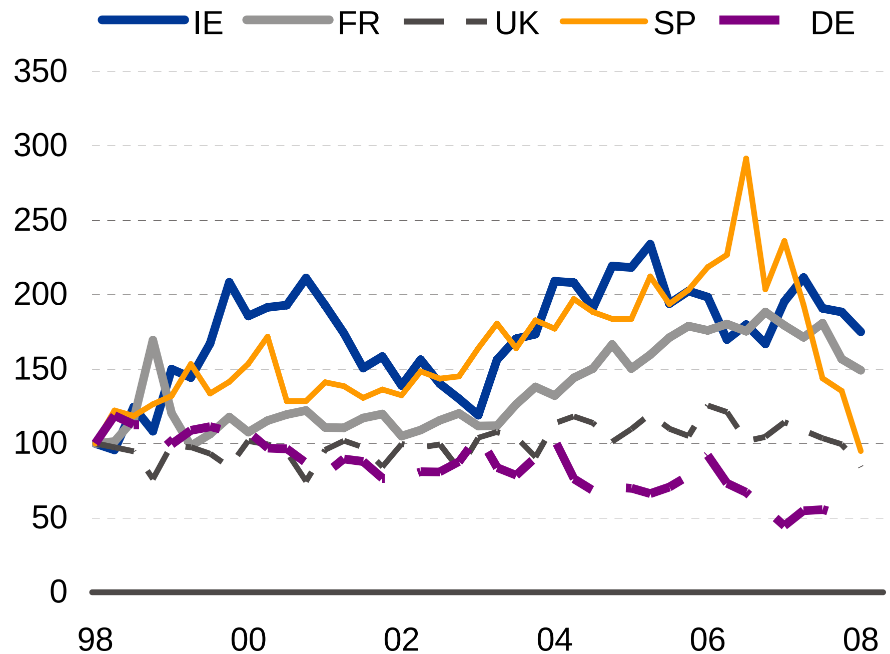
1996=100



Sources: BIS, ECB, Nationwide, INSEE;
MVIV, OFHEO, TSB, BulwienGesa

Residential building in Europe permit - more downward pressure

Residential building permits, 1998=100



Sources: Eurostat, OECD

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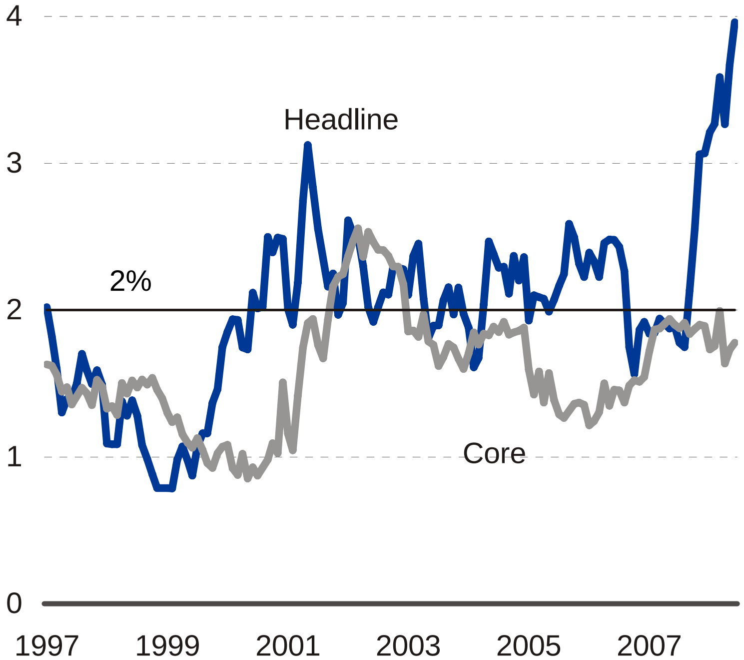
ECB to raise interest rate one more time?

EMU inflation rates

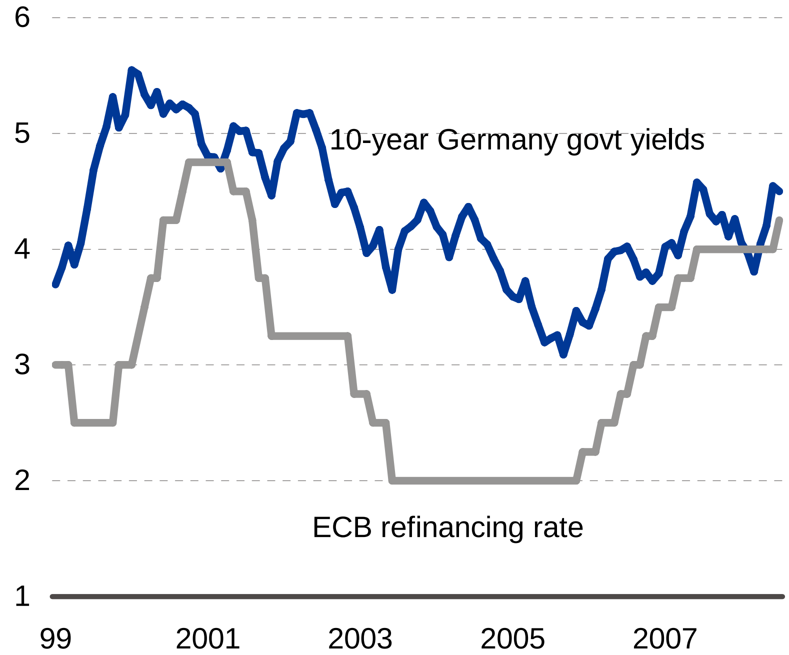
% yoy



Sources: NSOs, DBR forecasts from April 2008

Interest rates in EMU

in %



Source: Deutsche Bank Research

Rising Risk of Stagflation

- **Structural deficits make it most likely that the Euro economy is growing close to its low potential in the foreseeable future.**
- **High Inflation is long lasting all over Europe.**
- **Several European countries are on the brink to a recession due to necessary corrections in their construction and real estate sector.**

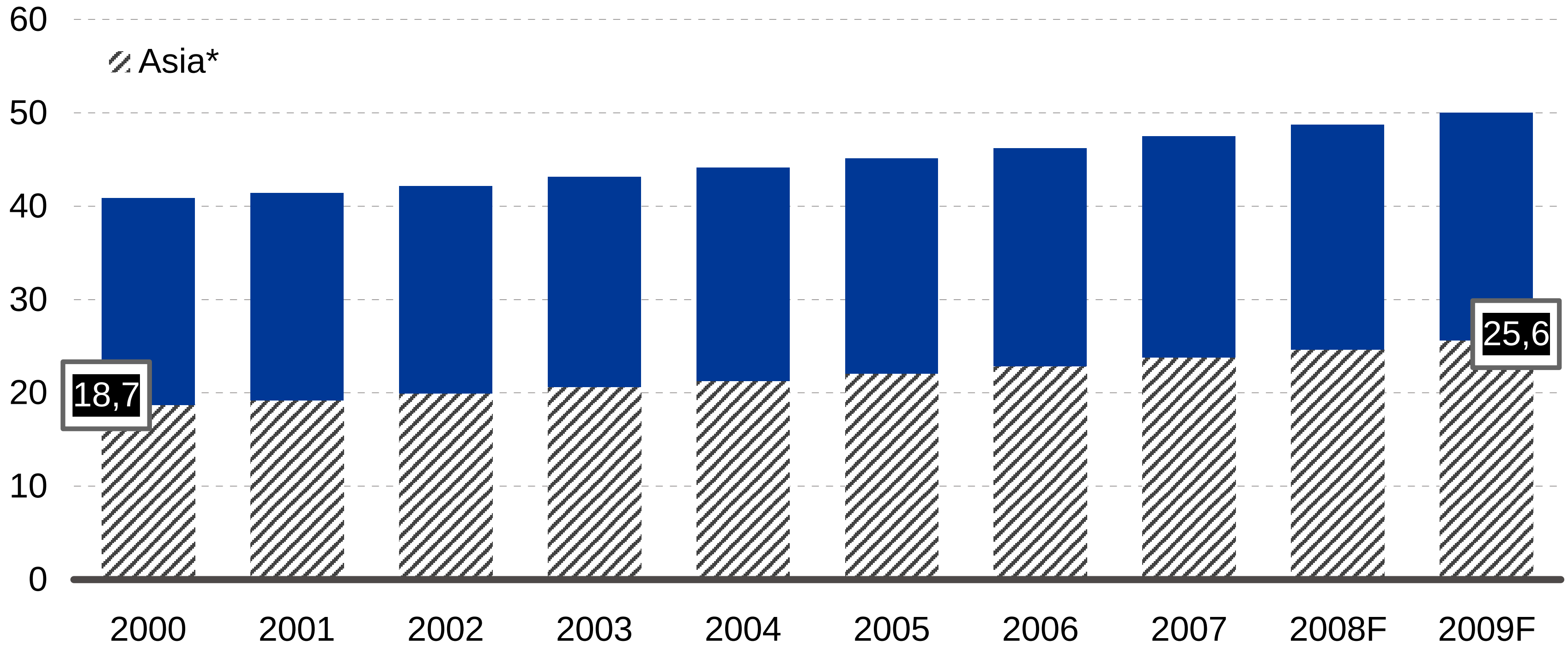
4

Emerging Markets

The last pillar of global growth challenged

EM & Asia: Rising importance in the global economy

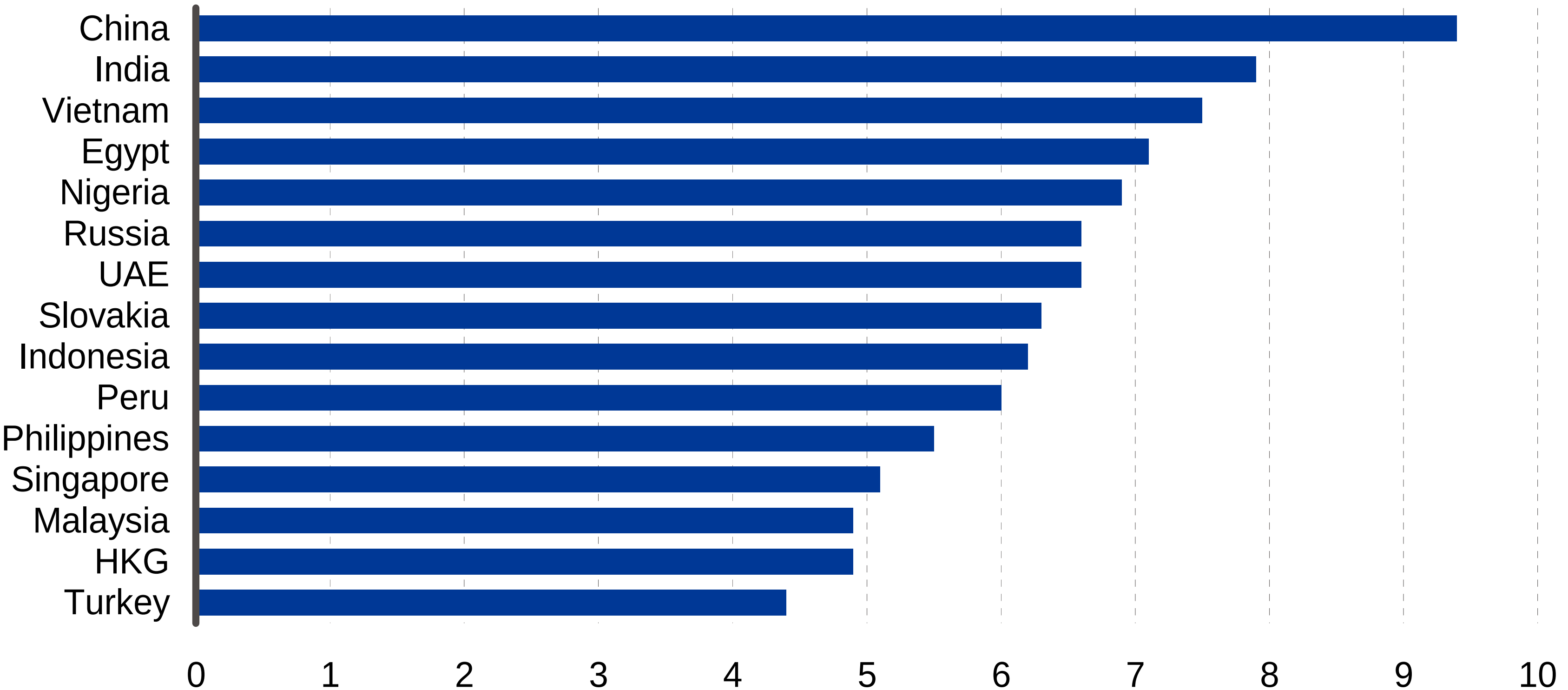
Share of EM and Asia in world‘s GDP
% (at PPP)



*Without Japan. Source: IMF WEO

Asia dominates growth league

Real GDP growth, average 2008-2011, %

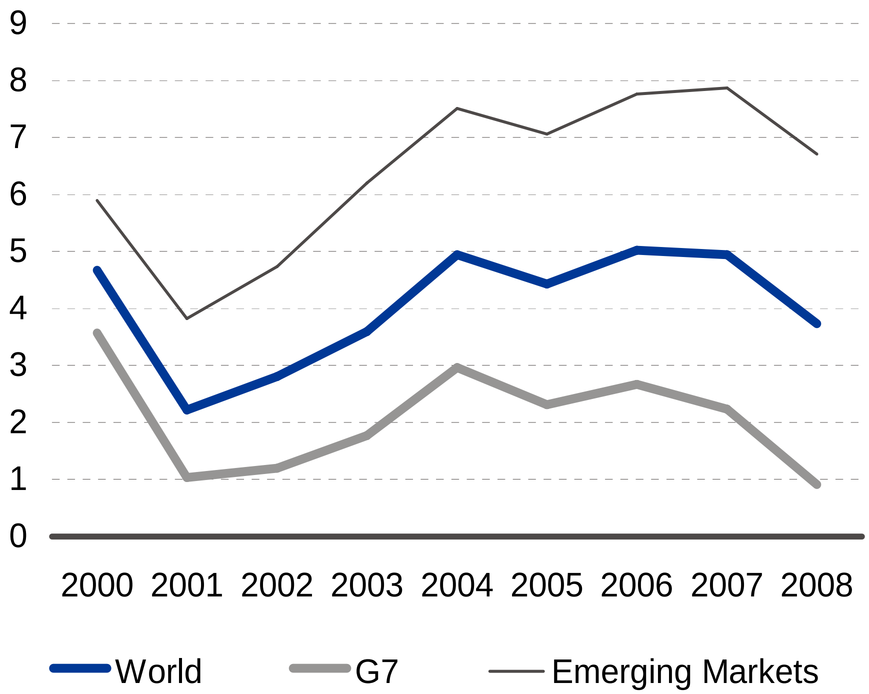


Source: DB Research

Emerging Markets still growing relatively strong

EM vs G-7 growth

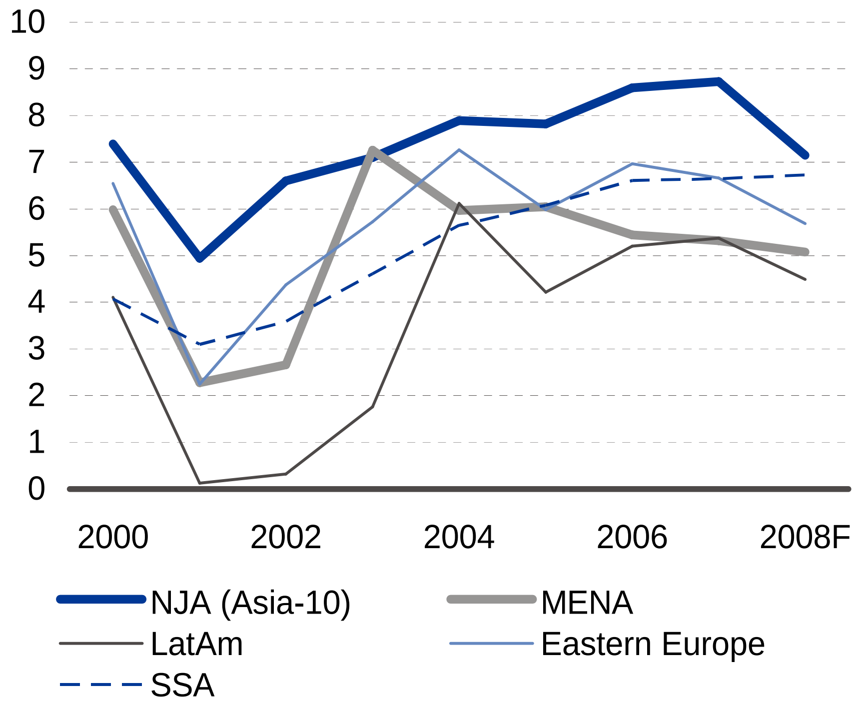
% yoy



Source: IMF (WEO)

Asia-10 still on the top

% yoy



Source: DB Research

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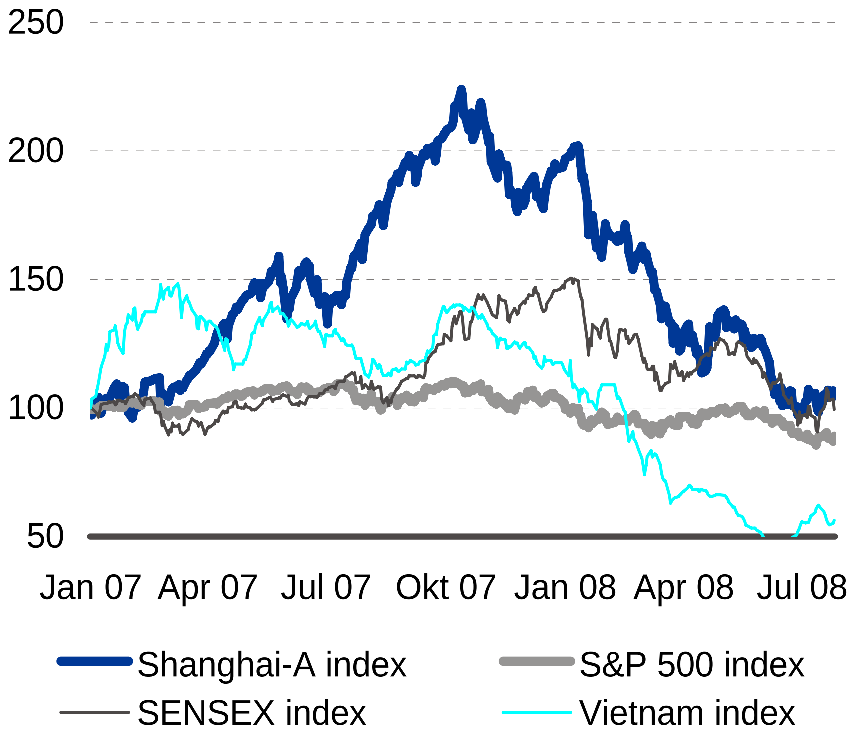
Current global financial turmoil hits Asia

Asian stocks get hit

Index Jan 2007=100



Source: Global Insight

- Stock and bond markets will likely suffer - bias toward buying “real” store of value as gold and hard commodities.
- Real estate markets should hold up reasonably well – but rising interest rates and poor growth outlook will cap the upside this year.
- Corporate and FI credit outlook stable at best – more vulnerable to negative outlook.

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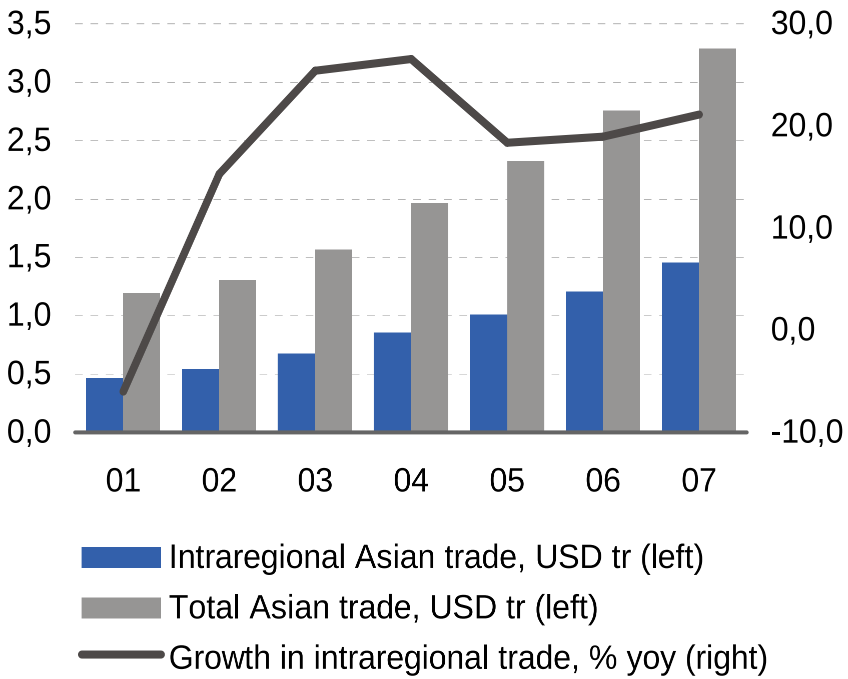
Still dependent on the US but raising Intra-regional trade

Rising intraregional trade



Sources: IMF, DB Research

- Asian trade has expanded significantly, export-led growth model is still predominant.
- But US slowdown has a significant impact on Asian growth prospect.
- But Intra-regional trade has been expanding more rapidly and now makes up over 40% of total trade.
- Less dependent from US growth.

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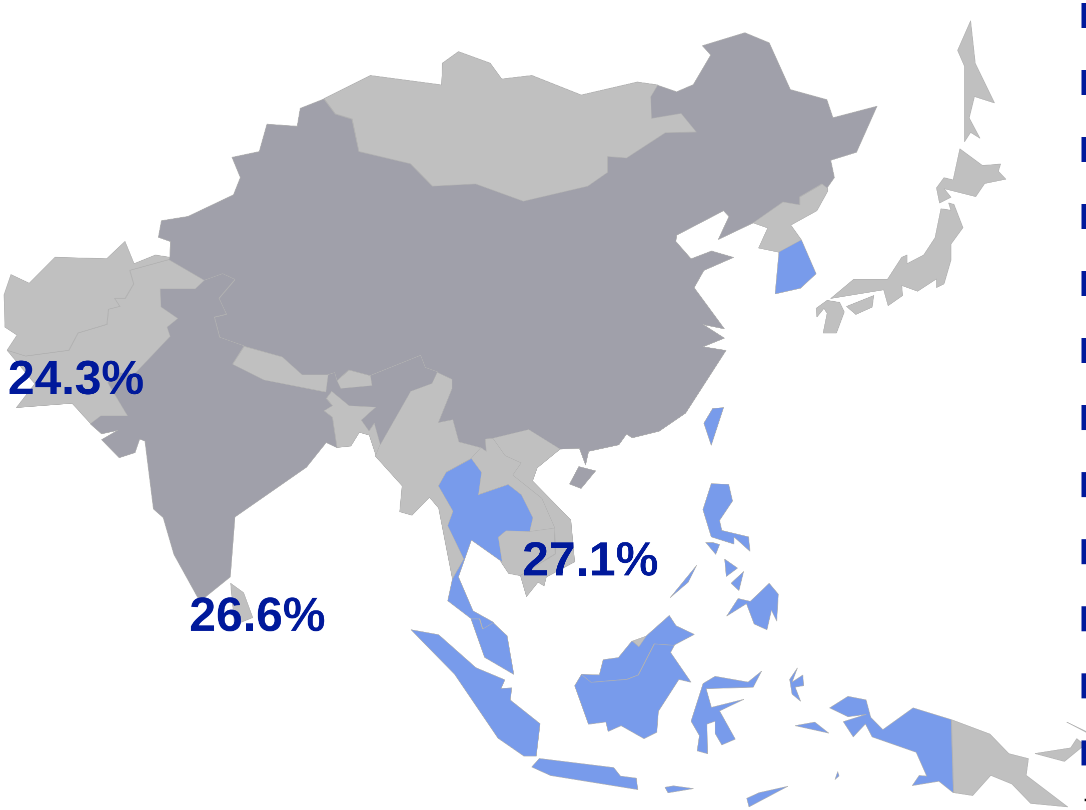
Too high inflation all over Asia



Inflation Rates:

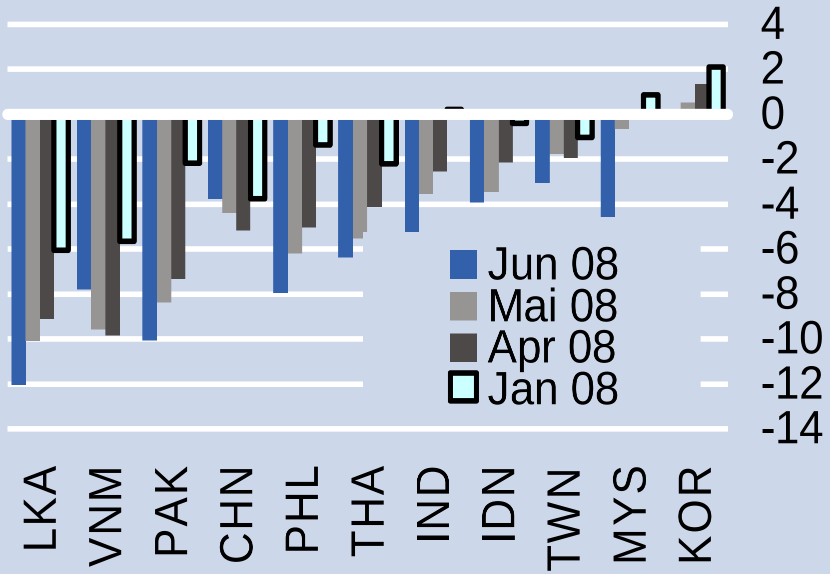
- China: 6.3%
- India: 12.0%
- Vietnam: 27.1%
- Thailand: 8.9%*
- Indonesia: 11,9%
- Malaysia: 7.7%*
- Philippines: 12.2%
- South Korea: 5.9%
- Pakistan: 24.3%
- Singapore: 7.5%*
- Sri Lanka: 26.6%
- Hong Kong: 6.1%*
- Taiwan: 5,9%

July 2008, *June 2008 yoy.

More tightening to come

Central banks behind the curve

Real interest rates*, %



* 3M LCY deposit rates minus headline inflation

Sources: Bloomberg, CEIC, DBR

- Many Asian central bank rates are below inflation rates.
- High energy- and food prices driving inflation.
- Declining subsidies for fuel and food in many emerging markets are accentuating the rise in measured inflation.

Will emerging and developing countries follow DCs into a cyclical downswing in 2009?

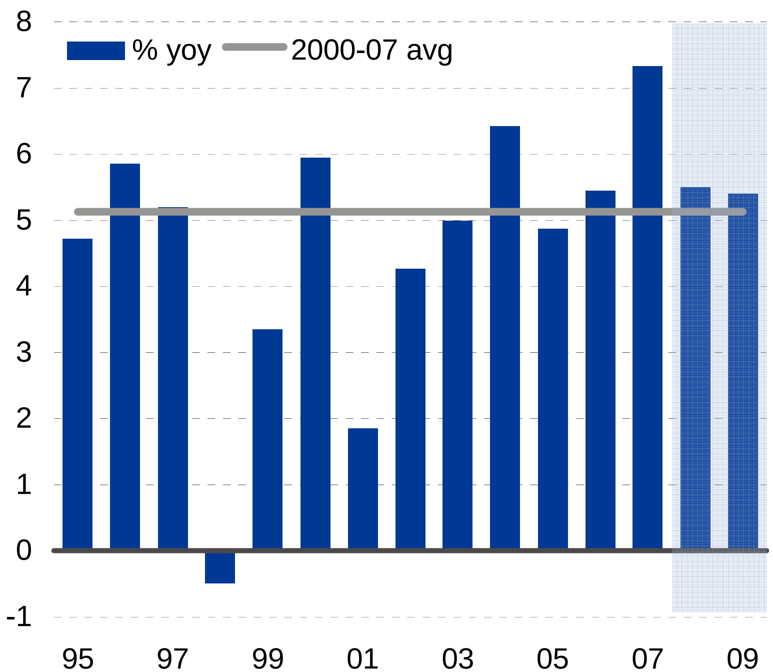
- **US financial market turmoil also hits Emerging markets.**
- **High inflation will force most Asian economies to increase their interest rates and allow their currencies to appreciate.**
- **Thus the Asian economic momentum will be weakened as of 2009.**

5

Philippines
Weathering the storm

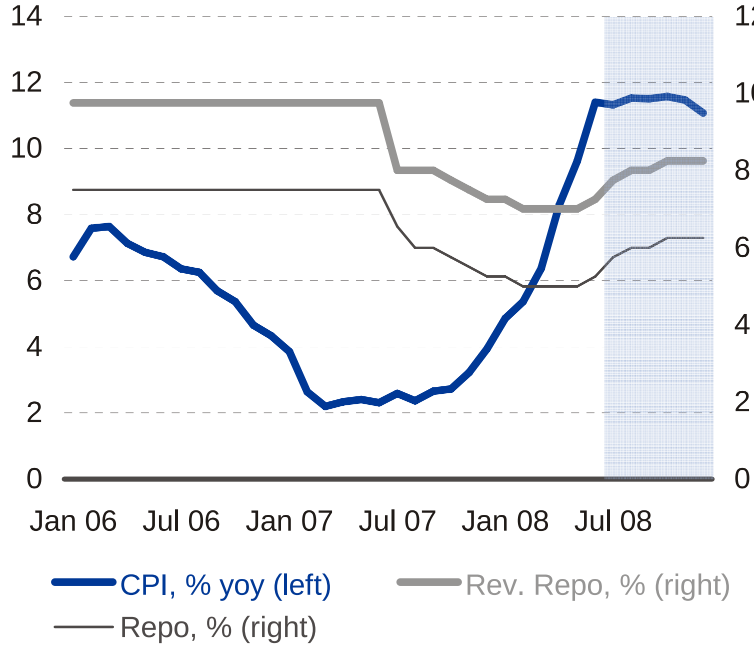
Macro fundamentals still okay but inflationary pressures are high

Growth to slow from 2007 high



Source: DB Research

Rapidly rising inflation forces BSP to tighten

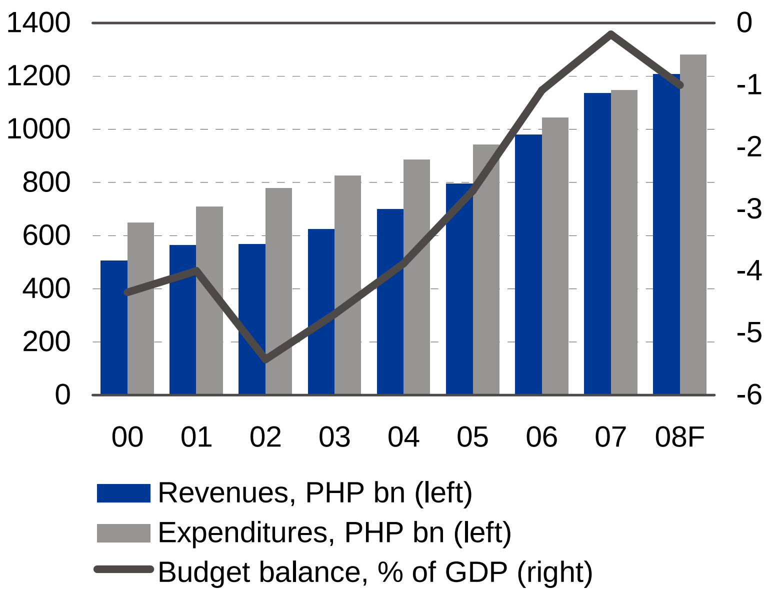


Sources: Bloomberg, DB Research

High inflation takes its toll on the fiscal front and amplifies financial market turbulences

Balanced budget goal postponed

National government



Sources: DoF, IIF, DB Research

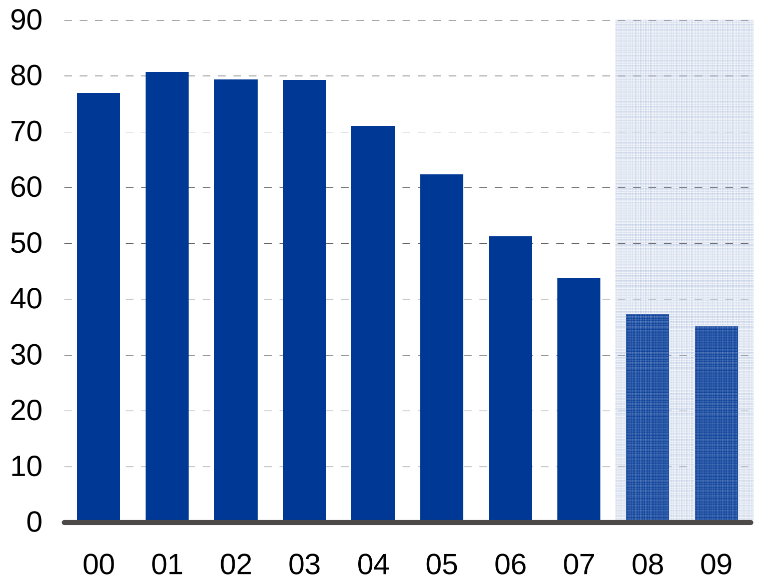
Financial market rollercoaster

Sources: Bloomberg, DB Global Markets

Healthier external position supportive in challenging environment

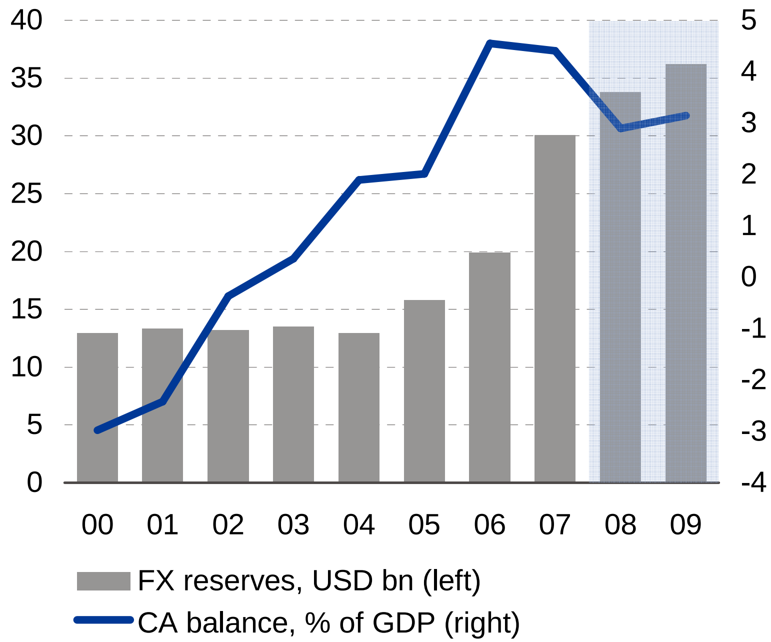
External debt will continue to decline - but at a slower pace

% of GDP



Sources: IIF, DB Research

Higher FX reserves on back of CA surpluses



Sources: IIF, IMF, DB Research

6

Conclusion

Damned fragile world

Degree of uncertainty – a few extra standard deviations

- **Variance of forecasts as an indicator**
- **Divergence of monetary policy – will the ECB find followers?**
- **Main global risks:**
  - **Inflation**
  - **Exchange rate movements**
  - **Global imbalances**

Global downside risks

What else to be aware of:

- **High inflation may un-anchor inflation expectations; monetary policy at risk to lose its credibility.**
- **Further large write-downs and spectacular bankruptcies would cause extra financial market turmoil**
- **Protracted global slowdown could lead to more protectionism – Doha Round failed.**
- **Mid-East, Syria, Iraq, Iran, Afghanistan/Pakistan tensions escalate and oil price soars further**