

# BUSINESS FORECAST '96

## Setting a New Course

**Asian companies and governments did their homework last year, cooling overheating economies and gearing up efficiency and competitiveness. From India to Japan, they have set the stage for steady growth and stable prices**

*By Ricardo Saludo*

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**WHAT DOES A FOREIGN** investor in China do when local business costs rise?

Answer: Move to China. Or rather, move elsewhere in China. That's what the Australian industrial group Pacific Dunlop did when it found the cost advantages that lured it to the Shenzhen Special Economic Zone (SEZ) outside Hong Kong fading. Its \$150 million investment in China is Australia's biggest and its \$12-million Olex Cables plant in Shenzhen, commissioned in 1988 and expanded three years later, is Pacific Dunlop's flagship in the country.

In November, group managing director Philip Brass said some operations were shifting from Shenzhen to cheaper Tianjin, near Beijing. The company was having difficulty keeping skilled workers in Shenzhen, now one of the most expensive manufacturing areas in China. To top it off, this year the central government is withdrawing many tax breaks granted to foreign investors in the SEZs. Further down the road, said Brass, the group would be moving more of its Shenzhen business to new facilities in Sri Lanka and Indonesia.

In Asia's dynamic economies, rising costs constitute the biggest challenge facing business. Companies have to cope not only with increasing wages, rents and raw material prices, but also with the tighter money imposed by higher interest rates instituted to dampen inflation. Last year global liquidity took a dive after Alan Greenspan, the U.S. Federal Reserve chairman, cranked up interest rates to beat back the stirrings of inflation in America and defend the falling dollar. Asian governments danced to the same tune, lifting their own lending charges to rein in domestic prices and international deficits.

"In 1996, Southeast Asia will continue to battle inflation," says Samantha Teo, a senior portfolio manager at Nikko Capital Management in Singapore. "Interest rates are likely to stay high in Indonesia, where they are still well below historic highs in real terms." She also sees further increases in Malaysia. With rising affluence and business growth, Teo sums up, "there is too much money chasing too few goods. Current-account deficits and infrastructure bottlenecks won't go away so soon in Thailand, Indonesia and Malaysia."

Down in Singapore, Berry Kwock shares Teo's concerns. The group finance director of Asia Pacific Resources International Holdings says the pulp maker is always seeking to cut costs and improve efficiency. Its two plants in Indonesia -- including the world's largest single-line pulp mill -- amount to more than \$2 million in investments. "Pulp production is highly capital-intensive," Kwock says. "Labor and rentals are not a major portion of our overall cost structure, so inflation has no significant effect on our business." Higher interest rates and dearer raw materials and utilities do, of course. But in a competitive market, Kwock prefers not to burden customers with price hikes. "We believe in continuous improvement to control costs," he says. "We watch commodities markets and buy ahead of requirements."

So how is all this going to make 1996 a better year? In a word: homework. Asian governments and companies did much of it last year -- restraining credit, trimming corporate fat, lifting productivity -- to cool overheating economies and gear up enterprises for competition. Another big factor: lower U.S. interest rates, which could lead to easier money in Asia and the return of American funds to the region's markets. "The general liquidity trend does seem to be in the right direction," says Carlton Poon, a strategist at Hong Kong investment firm World Sec. "Regionally, the likelihood is that after raising interest rates, several economies will see them decline -- and much quicker than in the U.S."

America itself is set to continue as an expanding market for Asian goods. "The U.S. is on a very good track," says Arup Raha, Hong Kong-based senior economist at Lehman Brothers. It has settled into a period of modest growth with low inflation, unheard of in decades. With interest rates creeping down, investment by U.S. companies, institutions and individuals is expected to revive -- and spill into Asia. Europeans meanwhile are likely to focus on preparing for monetary union. Growth will be modest, but monetary and fiscal policy will be kept under tight rein.

To be sure, there are immediate worries brought on by political factors, such as the U.S. budget standoff and the French anti-reform strikes. But if anything, such turmoil is likely to make Western investors turn to stable, pro-business Asian countries. "I'm quite positive on Asia for 1996," says Raha. "All the major economies will do well." The scenery seems in place for sustainable, non-inflationary growth in major countries. Alois Bischofberger, chief economist of Zurich's Credit Suisse, forecasts 7% regional growth for emerging Asian economies. China should still set the pace, while Japan could see a rebound at last. "With a slightly longer-term view," Raha adds, "Malaysia, Korea, Thailand and Indonesia are good prospects."

"What China has done is bring down inflation without taking a severe hit on growth," the Lehman economist explains. As 1995 ended, officials announced that the retail price index rose 14.8% for the year, against a 15% target and down from 21.7% in 1994. The State Statistical Bureau has forecast 8.7% average yearly GDP growth for the rest of the decade, with 8%-to-9% inflation. "There is no cause for worry in China" over inflation and deficits, says Raha. The currency reserves are healthy and growth strong. Still, Chinese planners aren't letting down the guard. Central bank governor Dai Xianglong aims to keep money-supply growth lagging GNP. Finance Minister Liu Zhongli says China will begin trimming budget deficits under the Ninth Five-Year Plan starting 1996. Enterprise and financial reform are key priorities. Efforts to boost food production are continuing, as are restraints on credit and speculative investment.

The squeeze has forced Chinese firms to get more efficient. That, says Raha, will help Beijing make the difficult selection of which firms need to be retained, restructured or closed. China National Foreign Trade Transportation Corp. or Sinotrans (est. 1950), isn't planning to join the scrap heap. The freight forwarder and ship charterer has grown into a major shipowner with 1.8 million deadweight tonnage and 45 international routes in service. It has about 100 joint ventures, with half in China and the rest abroad, mainly in Asia. But a third of its fleet is over 15 years old, so Sinotrans is trying to modernize. It has ordered six bulk carriers from a Japanese yard and a couple of smaller container ships from a Korean one.

Vice-president Yang Jianguo complains that despite more than \$600 million in turnover and three years of profits, Sinotrans is short of funds for expansion and modernization due to Beijing's austerity measures. The gripe is nationwide: three out of every five managers of state firms say loans are fairly scarce or just too difficult to get. But more than grumbling, Yang is looking to cut costs and improve efficiency to build up resources for investment. Easing inflation will help Sinotrans along. And it has an edge: it embraced new technology early on, being one of the first to computerize customs clearance and other port operations.

Rather than China's steadier growth, Japan's recovery from its most severe postwar recession may well turn out to be the economic highlight of 1996. "Japan will pick up," says Raha. Three

factors are expected to help revive the economy. Some \$80 billion in public spending is due to start flowing in April. Second, Tokyo seems to be finally getting serious about the mountain of bad banking debts. Last month it announced a plan to bail out housing loan firms with some \$6.8 billion in tax money and the writeoff of more than \$60 billion owed to domestic banks. Such moves should help revive overall credit in a banking sector dogged by fears of collapse. Lastly, exports are tipped to pick up with continued global economic expansion, the yen's expected decline -- to 110 per \$1, by some predictions -- and the impact of years of cost-cutting and efficiency-boosting by Japanese firms.

India too looks like it may be starting an expansionary cycle -- if concerns about politics and inflation don't materialize. Unlike many other international analysts, Raha believes parliamentary polls due before July won't change New Delhi's economic policies radically. He sees little essential difference between those espoused by the ruling Congress party of reformist Prime Minister P.V. Narasimha Rao and by the Hindu rightist opposition. Both platforms aim to develop Indian business through foreign links while differing on the kinds of tie-ups to pursue. Like China's rulers, India's leading parties favor gradual reform and are careful about dismantling price controls and subsidies on prime commodities and farm inputs. Meanwhile, the South Asian Preferential Tariff Agreement, which took effect Dec. 8, is expected to boost trade and help hold down prices in products made in the subcontinent.

The encouraging prognosis for Asian inflation has even made some of the more sanguine analysts wonder whether rising prices are a real problem. World Sec's Poon sees higher prices as part and parcel of economic growth. "Inflation is a problem of success," he argues. "It's better than problems of failure." Raha attributes much of last year's inflationary pressures to food shortages, which should disappear barring natural disasters or crop failures. In Japan, of course, the problem is falling prices amid recession and liberalization. Indeed, for Sabah lawyer Joseph Ambrose Lee, who runs K.L.-listed timber firm CASH, "the fear of inflation is illusory, at least in Asia." His argument: With much untapped labor and resources, the region still has much growth in store to cope with inflationary demand, unlike mature Western economies.

Some of the region's monetary tightening in 1995 was also intended to reassure international investors shaken by the Mexican peso's dive a year ago. Credit Suisse's Bischofberger dismisses fears of similar debacles in Asia. "While current-account deficits of South Korea, Malaysia, the Philippines and Thailand are deep, they are the result of huge imports of plant and machinery," he explains. "Much of this will be used for export. The deficits carry within them the seeds of their own redemption. The shortfalls are financed by long-term capital inflows, notably direct investment, [which] act as a cushion against any sudden loss of confidence."

Of course, it does not take double-digit inflation to prod businesses into cutting costs and improving efficiency and quality. The lure of larger earnings and the threat of going bust are enough. In the New Asian Economy, both profits and fears are on the rise as markets open up, customers trade up and competitors toughen up. Arab-Malaysian Banking Group is a giant in Kuala Lumpur. Yet CEO Azman Hashim, 56, who once limped away from his smashed Porsche, worries about financial liberalization. "In the private sector, we don't like this opening-up business," he admits. "We'll be gobbled up. We're not Mike Tyson yet. We must be given as much time as we need to get ready." The heavyweight boxing fan favors mergers among local institutions and tie-ups with foreign ones "to build ourselves up into Mike Tyson. We need the economies of scale to be globally competitive."

Paul Selway-Swift, executive director of the Hong Kong & Shanghai Bank, also worries about deregulation. Last year, the government began breaking up the local cartel in savings and time deposit rates, leading to increased competition for retail funds. Banking authorities opted to delay further liberalization -- but not scrap it. Hence, Selway-Swift sees efficiency and diversification as crucial in 1996. His strategy: Restrain wages and bad-debt provisions and develop new sources of income. Hongkong Bank pins its hopes on lower U.S. interest rates, a Hong Kong property

recovery and better prospects for China's economy. But costs remain key: for the city's ten listed banks, expenses rose 11% last year, right behind revenues up 16%.

**I**T IS THE SAME story for Cathay Pacific. Last week the Hong Kong flag carrier scrapped a plan to move its pilot school to Australia, but only after it was promised land at a cut-rate price. Indeed, in Asia's dynamic economies, the prices of land and other assets are becoming just as important as living and operating expenses. For real-estate tycoon Philip Ng, whose family is Singapore's largest landowner next to the government, rising property prices are the major cost. As a developer, of course, he also benefits from real-estate inflation, which Ng attributes to the Lion City's ever-expanding and upgrading infrastructure. That and the more and more lucrative opportunities in Asian economies will inevitably boost asset values, from office blocks to blue-chip stocks.

And there's the rub. While Asian consumer price indexes (CPIs) seem set to fall as economies open up, asset inflation is emerging as a new bane (or, if one has assets, a boon). From Bombay to Seoul, Beijing to Singapore, companies and citizens by the millions have seen real estate inflate beyond their means. One top Lion City economist points out that traditional CPIs put the biggest weighting on food even when affluence has shifted spending to other items like housing, education and health care. Last week, as Beijing trumpeted its right-on-the-mark inflation figure, fares in the capital rose between 100% and 300% to help loss-ridden bus and subway firms. Residents binged on cars amid news of reduced motor registration quotas and an impending 30% hike in auto prices.

In sum, for more and more Asians, economic growth brings the mixed blessings of higher incomes but unaffordable assets. Peregrine Capital Vietnam chief Nguyen Trung Truc points to the rise of an urban elite atop the largely rural poor. It's the same in Cambodia. Truc expects it would take two to four years for the masses to begin to buy the comforts of the wealthy few. As in Indochina, reforms in China and India have created a similar class-based inflation, where prices of many basic goods match the purchasing power of only the well-to-do. Some reforms exacerbate the situation. Cambodia's new tariff system is expected to create a two-tier price system, one for the rich, the other for the rest.

Similarly, certain companies can better cope with costs than others. Thailand's agri-business group Charoen Pokphand passes on much of its inflation to consumers. For Thai Airways International, efficiency is often the only recourse. But all enterprises must eventually submit to market forces and the bottom line. Conforming to those disciplines, while flexibly responding to the rise and fall of prices, is in the long run the ultimate formula for Asian success.

*-- Main reporting by Alejandro Reyes/ Hong Kong and Steven K.C. Poh/Kuala Lumpur*