ARTICLE FOR THE EDGE

THE RISKS THAT MATTER FOR THE REGION

The world economy has not had it this good for well on a decade. Virtually every corner of the globe is enjoying growth except for countries suffering political or other crises. With the immediate threats to economic growth allayed, however, new risks are appearing. Media reports have focused on geo-political risks such as North Korea but there are growing financial risks as well as a cloud of concern over the global trade regime that is so vital for the regional economies.

So, what are the risks that really matter and how exposed are regional economies to them?

Geo-political risks: unquantifiable and unpredictable, but probably not an imminent concern

There has been much written in the media about North Korea's nuclear programme and China's assertive conduct in the South China Sea. These concerns certainly have substance but the tensions are unlikely to crystallise imminently. We suspect that potential convulsions in the Middle East could pose more of a threat.

North Korea captures the imagination because it is one of those low-probability but high-impact risks that no one dares to ignore. President Trump and North Korean leader Kim Jong Un's highly colourful threats against each other have also added to the concerns -and with good reason. Analysts estimate that even a non-nuclear clash could result in hundreds of thousands of deaths within the first few hours as a result of the massive artillery barrage that North Korea could unleash on Seoul, South Korea's capital. A conflict involving nuclear weapons would cause millions of deaths.

Given the immense consequences, no matter how bombastic the rhetoric is from each side, it is unlikely that the key players - North Korea's leaders, the Trump Administration and China - are irrational. Each side has clearly defined objectives and all share a desire to avoid a war. The North Korean regime wants to ensure its survival, the US is determined to limit any nuclear or missile threat to its heartland and China seeks to maintain a buffer state between itself and capitalist, US-allied South Korea where 25,000 or so US Marines are based. We are not yet at a point where any one party has concluded that the risks to themselves are so awful that a military option is the only way to secure themselves. The US realises that there is no practical military option - North Korea's artillery would destroy Seoul well before even the most sophisticated American weaponry can take it out, and anyway, the Americans and South Koreans probably do not have sufficient intelligence to know exactly where all the North Korean nuclear and missile facilities are located.

That means that, in the near term at least, the US, South Korea and Japan have no choice but to accept the reality of a nuclear-armed North Korean and learn to deter and contain it. As part of that approach, the US will keep ratcheting up sanctions on North Korea. But to really hurt North Korea, the US will have to target Chinese banks and companies that are North

Korea's main source of vital finance and materials. So, one thing is clear – we don't have to worry about a nuclear war for now but US-China relations will certainly come under strain in coming months – a reversal of the current appearance of bonhomie evident during President Trump's recent visit to Beijing.

In the South China Sea, we would argue that risks have receded, at least for now. Having secured its strategic objectives by building military facilities on the rocks and shoals it occupied, China can now afford to take a more amiable stance. It is negotiating a code of conduct with its Southeast Asian neighbours to limit the chances of a clash and stepping back from an overtly aggressive posture. This recalibration is also evident in other arenas – as seen in how it has stepped back from its harsh sanctioning of South Korean interests in retaliation against South Korea's hosting of American missile facilities.

The Middle East, though, could be on the brink of a new round of conflicts.

- First, within Saudi Arabia, the ruling House of Saud appears convulsed with a dangerous internal power play as a result of Crown Prince Mohamad bin Salman's arrest of senior princes and other leading officials. It is not clear what this will lead to – will there, for instance, be a backlash against the Crown Prince that would result in prolonged tensions in a once-stable country? Whatever the case, Saudi Arabia which has been a rock of stability in a highly volatile region, is now experiencing its worst political crisis in decades.

- Second, tensions have also risen sharply between a Saudi-led coalition on one hand and Iran and its Hezbollah ally in Lebanon on the other hand. There is also talk that Israel could take advantage of this situation to attack Hezbollah. One cannot rule out yet another war in Lebanon.

If these tensions escalate, producing an unstable Saudi Arabia or another war in Lebanon, there will be repercussions for our region. Oil prices would certainly spike up further and that would set back the global economic upcycle. Another consequence could be higher risk aversion among financial investors could result in capital being pulled out of the region to be deployed in safe havens such as the US and Japan – causing havoc in Asian currency and other financial markets in the process.

The risks of financial turbulence cannot be ignored

Global financial markets worry us. These rely on liquidity of which there has been a surfeit in recent years. Without the gift of bountiful liquidity from the central banks, asset prices would not be as elevated as they are now. But, two threats to that liquidity are now emerging. One is that central banks are beginning to claw back on this liquidity – most of all in the US where policy rates are being raised and the quantitative easing of past years is actively being reduced. The other is that the growing needs of the real economy are absorbing more of the available liquidity, thus leaving less for deployment in financial markets. In short, the ample liquidity that boosted financial asset prices will be receding.

History tells us that a prolonged period of easy liquidity and super-low interest rates tends to encourage risky financial behaviour. And, almost always, the worst forms of such risky conduct only become apparent long after some crisis or shock happens. In China, imbalances created by excessive credit creation have built up to a point where even the People's Bank of China Governor, Zhou Xiaochuan has warned of a "Minsky" moment, when a financial crisis could erupt without warning. Most people assume that the policy makers in China know the problem and have the resources to contain it – but what if they are wrong?

So, the vulnerabilities are building, but are there the triggers which could turn these into an outright shock of some kind? An abrupt recalibration of risks by investors could do the trick. This is possible, for instance, should there be a sudden change in investors' views about the pace of US monetary tightening. That would happen if economic growth surprised on the upside. Currently, there is a perception that the current global rebound will taper off next year and so allow central banks to adhere to their strategy of raising rates in cautious increments. If growth were to accelerate and inflation risks rise ahead of expectations, we could well get that sharp re-calibration of investor expectations. Another trigger could be a geo-political shock of some kind – which as explained above cannot be ruled out.

The rising threats to Asia's trade engine

In an earlier column, we outlined the dangers that the Trump Administration's approach to the World Trade Organisation, the North American Free Trade Agreement (NAFTA) and the Korea-US Free Trade Agreement could pose to the global trade regime which has allowed Asian economies to enjoy high growth through an export-led strategy. Now, two recent events reinforce that concern.

First, President Trump's recent tour of Asia sent a clear message – he sees trade agreements from a zero-sum perspective, is inordinately pre-occupied with bilateral trade deficits and is focused on manufactured goods trade where the US is less competitive and not on services trade where the US is competitive. It is reasonable to fear that, once the US concludes the current re-negotiation of NAFTA, his trade team will turn its attention to Asian economies which run large deficits with the US. Then Asia will feel the heat.

A further risk lies in the tax reforms that are currently being debated in Congress. While the exact composition of the tax reforms is not known yet, one thing is clear – what the US Congress will pass will not be a tax reform as much as a straightforward tax cut. Given the way American politics works, this tax cut will produce a huge increase in the budget deficit – likely to be larger than the USD 1.5 trillion over 10 years that Congress claims is the maximum. But adding such a large fiscal stimulus to an economy which is already near full employment will only add to inflation and swell the American trade deficit since imports will soar. The Trump Administration is unlikely to blame itself for the larger trade deficits – it will almost certainly lay the blame on competitive exporting nations, accusing them of unfair trade practices and manipulating their currencies. And that will lead to more protectionism.

There are countervailing forces trying to stem the tide against trade. But their efforts against these growing challenges have been inadequate. Yes, eleven Asia-Pacific countries did overcome differences to agree on a revised version of the Trans-Pacific Partnership (TPP) which President Trump had hobbled when he pulled the US out of it just three days into his presidential term. Another large group of countries in the region is edging forward in efforts to complete negotiations for the Regional Comprehensive Economic Partnership (RCEP) which will bring together all the large economies of Asia including China, Japan, India, Australia, Korea and ASEAN among others. However, both the revised version of the TPP and the RCEP are far from being finalized – and could still founder on various member countries' conflicting demands.

The bottom line

In sum, there are three key risks that we see for Asian economies in the near term. First, there is a rising chance of conflict in the Middle East that could send oil prices soaring. Second, financial risks could be triggered if the global economy does a lot better than expected. And, finally, Asian exporting nations running large trade surpluses with the US should expect more trade tensions with the US in the coming year.

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