ARTICLE FOR THE EDGE

REGIONAL ECONOMIES PRIMED FOR UPSIDE SURPRISE

Asian economic growth is set to accelerate. After a long period of patchy and unconvincing recovery, there are signs that the global rebound is gaining enough traction to be a durable one. Better still, this upward lift is supporting higher export growth in Asia. More encouragingly, domestic engines of growth also seem to be regaining some vigour. Overall this means that the regional economies have more buffers and so could be more resilient against political or other shocks that financial markets are currently worried about.

Global demand offering a more durable boost to Asian exports

The data released in the past couple of weeks has been strikingly positive. In the United States, the manufacturing sector is at its most vigorous since 2011, judging by the purchasing manager index. Global semiconductor sales are expanding at their fastest rate since 2010. In Europe, French business confidence is at its highest level since April 2011 and German business confidence is close to a record high. That is why bank lending in the Eurozone is recovering, with Germany leading the way – businesses are more confident about the future and are borrowing to expand, which suggests that the rebound will continue. Even in Britain, where concerns over the impact of Brexit are growing, the fall in sterling has boosted exports – surveys show the proportion of companies reporting booming export orders at a record high.

Encouragingly, this global recovery is now feeding more palpably into Asian export growth. Korean exports – a bellwether for global demand – have grown by an average of around 18% in July-August. Malaysia just reported that exports in July surged 31%. Better still, the brighter prospects for exports are translating into stronger industrial production. In Singapore, industrial production soared 21% in July, one of the highest growth rates the country has enjoyed in 5 years. The growth appears to have continued into August when Singapore's purchasing manager index reached its highest level in three years while the electronics index has not seen such high levels since November 2010. In Malaysia, surveys of purchasing managers show that higher export demand has boosted optimism among manufacturers to its highest level since December 2013.

Domestic turnaround more evident as previous years' negatives fade away

This year has seen the forces which dragged the region's growth down begin to reverse:

- First, bad weather in 2016 had decimated agricultural exports in Malaysia, with palm oil being the main casualty after production declined 8%. As weather conditions improve going forward, shipments are on track to recover with palm oil production growing 7.2% in 1H17. Thailand has also shed off the ill-effects of drought in previous years. Coupled with a turnaround in soft commodity prices, farm incomes have improved markedly, leading to the paring down of debt and higher consumption.

- Second, growth in some countries in the region had been hurt by the impact of reforms that were necessary for the long run but which in the near term hurt the economy. For example, in Malaysia the inflationary effects of the implementation of the GST in April 2015 have subsided, allowing private consumption – which grew at a blistering 7.1% in 2Q17. Similarly, in Indonesia, President Jokowi's bold but unpopular fuel subsidy rationalisation initially hurt the economy as consumer confidence was hurt – but now those ill effects have faded. In addition, central banks across the region had to impose macroprudential policies so as to clamp down on speculative activity and cool the growth of household debt. This was the case in Thailand, Malaysia and Singapore since 2011 – but now consumers have adjusted to the measures and are no longer holding back on spending because of those measures.

Government expenditures an additional boost to domestic demand

The public sector has been a reliable fall back for many economies in times of economic softness, particularly in early 2015 when the global economy was in a trade funk. Governments opened their coffers and poured financial resources into the economies in a bid to reignite growth rates and support structural transformations. In recent quarters, government consumption expenditure across the core ASEAN economies has supported growth, particularly in Singapore and the Philippines.

The missing ingredient in the domestic demand story has been investment

The big disappointment has been investment. In the second quarter of this year, investment contracted in Singapore and Thailand, with public sector investment mainly responsible for the decline. This means that falling government investment has become a drag on growth after stimulating the economy from early 2015 through the middle of last year. In Malaysia, the growth in investment slowed to just 4.1% in the second quarter from 10% in the first quarter while Indonesia has seen steady but unspectacular growth of investment in the low single digits. It is in the Philippines, though, where investment growth has surged, up by around 12% in the first half of this year.

For domestic demand to be a sustainable engine of growth, we need to see investment recover more strongly. There are some glimmers of hope:

- In Singapore, bank lending has recovered since late last year. Loans to businesses are growing at a steady pace, suggesting that companies are becoming more hopeful that future demand justifies expanding capacity.

- In Thailand, the private investment index is slowly inching ahead, although the growth rate remains tepid. However, a surge of public sector investment in mega infrastructure projects has been evident, with a big uptick in contracts awarded for major projects such as mass transit lines and new highways just in the last few months. It is quite likely that the private sector will be more confident once these projects are seen to be actually moving ahead. Already, state enterprises have shown the way with a 20% spike in their investment in the second quarter.

Looking ahead: prospects remain good for ASEAN

We think there is good reason to remain confident that the uptick will be sustained:

First, the lead indicators for growth in the region remain good. The official lead indicators are rising across most of ASEAN. In addition, purchasing manager surveys suggest that new orders are flowing in strongly enough to sustain expanded production in coming months.

Second, we suspect that there will be further upside surprises in global demand. Economic activity is now expanding across virtually all parts of the globe with exceptions only in countries suffering political crises such as Venezuela or parts of the Middle East. The big developed economies are performing well and the OECD lead indicators suggest that this will continue. China's growth has stabilised and the latest purchasing manager surveys for both manufacturing and services shows that activity is holding up well despite government measures to cool real estate and bank lending. India appears to have finally put the shock of its demonetization and imposition of GST behind it, with the latest purchasing manager index finally moving back into expansion. Moreover, large emerging economies such as Brazil, Russia, Turkey, South Africa and Nigeria which have endured recessions in the past year are seeing a modest recovery.

It is the nature of such a globally synchronised recovery that recoveries in one region feed into others in a mutually reinforcing upcycle: that is how upside surprises to growth emerge. That makes the recovery more resilient to shocks, such as political or financial stresses.

Despite the signs of rising momentum, many observers remain concerned that the rebounds we have seen so far may not last. One reason has been the rise in geo-political and trade tensions. But is it likely that these concerns really hurt ASEAN?

- First, there is the crisis created by North Korea's nuclear and missile development. This is certainly an area of concern and where the risk has risen. But the military options are clearly extremely limited so the chances of the United States unilaterally taking action against North Korea are remote, especially given its ally, South Korea's adamant preference for a diplomatic solution.

- Second, it does seem that the Trump Administration is gearing up for more trade protectionism. So far, however, the divisions in the Administration have prevented the worst from happening. One area of potential concern is that the Trump Administration, frustrated with China's continued support for North Korea, takes more aggressive protectionist measures against China. However, even here, the risks are contained because of the great mutual interdependence between the two giants.

Implications: where will the shifts in policy be?

Within the region, one set of implications is on policy going forward:

- **Indonesia**: President Jokowi is under pressure to tackle lacklustre growth rates that have been structurally constrained. We are likely to see a cabinet reshuffle to bring in more energetic ministers to help the president revive growth. Bank Indonesia has cut rates and this accommodative monetary policy should continue with one more rate cut by early 2018.

- **Thailand**: The Thai economy is in better shape, buoyed by the export upturn. The military government will likely ensure policy support to the economy, in light of imminent elections in 2018. Fiscal policy will be focused on ensuring long-term, large-scale infrastructure projects get off the ground while monetary policy will be held steady at the already accommodative level.

- **Singapore** is in a sweet spot as growth looks to surprise on the upside while inflationary pressures are well under control. Government consumption will continue to rise due to demographic changes while government investment could rise to inject a dose of growth impetus when required. Looking ahead, we are not likely to see any changes to monetary policy in the upcoming monetary policy meeting in October 2017. However, should growth continue to steam ahead, the Monetary Authority of Singapore may deem it appropriate to restore the gradually appreciating slope of the policy band in its April policy meeting.

- **Malaysia** will be another outsized beneficiary of the rising tide of world trade. Both manufacturing and services clocked strong performances in the recent GDP release. With elections potentially looming large, Prime Minister Najib Razak could ramp up spending and the disbursement of pre-election sweeteners when he announces the 2018 budget in October.

- **The Philippines** is no longer the 'sick man of Asia', but rather one of the fastest growing economies in the world, thanks to reforms and policies instituted by President Duterte's predecessors. Duterte's massive "Build Build Build" infrastructure initiative will add to growth as will efforts by his respected economics team to streamline government regulations and procurement to ensure the timely disbursement and spending of appropriated government funds in the national budget.

In short, the overall prospects are good, the risks can be contained and policy makers are likely to move cautiously to continue supporting the economy.

Prepared by Manu Bhaskaran, CEO, Centennial Asia Advisors