ARTICLE FOR THE EDGE

GET READY FOR A BUMPY RIDE

In the past year, the global environment for Asian economies has grown ever more uncertain. The outlook for critically important drivers of Asia's well-being - demand for its exports, prices of oil and other key commodities, geo-political pressures, the functioning of the trade regime - are all subject to greater unpredictability. It might be useful therefore to identify the most important variables affecting the region's prospects and work out as best as we can where each is headed.

What emerges from this analysis is that pressures are building up in key areas. These are likely to trigger events which will increase the downside risks for the region.

Global economic prospects: Only the US is up, may be too strongly …

In our previous column, we argued that there was an unambiguous deceleration underway in global economic activity except in the United States where it was accelerating. This pattern has continued, with even greater evidence that the American economy could actually be overheating. In fact, recent data suggests that the American economy will see accelerating domestic demand accompanied by an expanding possibility that inflation and the external deficits could worsen.

- The Conference Board lead indicator has been rising steadily, up a robust 0.6% in July alone after several months of steady increases: there is little sign that above-trend growth will reverse any time soon. Rambunctious business confidence, a booming equity market and the unfolding effects of the fiscal stimulus tend to validate the lead indicator's robust signal.

- Capital spending is gaining momentum: This is a really big deal – when firms buy more equipment and expand factory space and production capacity, there are tremendous multiplier effects throughout the economy. There is every indication of accelerating investment – orders for core capital goods are rising at an annualized 11.3% in the recent three months.

- Consumer confidence is soaring: The Conference Board Consumer Confidence Index leapt to 133.4 in August, with confidence in current conditions at its highest level in 18 years. This confidence is percolating through to actual spending – core retail sales have been growing at above 4% in recent months.

In short, American economic growth is already too strong and is likely to get even stronger, raising the question whether the economy might overheat: There are two areas of concern:

First, most estimates place America's sustainable growth at around 2% but the economy is growing well above 3.5% with no let-up in sight. Unemployment is falling and we could soon come to an important inflexion point in the labour market where wages start to accelerate at a pace which the Federal Reserve Bank will find unsettling.

Second, when domestic demand exceeds domestic production capacity, an economy either suffers higher inflation or a larger external deficit or both – the excess demand has to go somewhere. Sure enough, the trade deficit is beginning to widen and we have little doubt that the broader current account deficit will deteriorate significantly in the coming year. Core inflation is already higher than the Fed's 2% target and may edge up more if above-trend growth pushes wages and other input costs up - and if more tariffs are imposed by President Trump as seems likely.

We think there is a very good chance that unemployment, wage growth, consumer inflation and the external deficits will reach levels that force the Fed to shift from its cautious pace of monetary tightening to a faster one. That would be very damaging to emerging markets.

… while other economies, especially China, are slowing

What about the rest of the world? The OECD lead indicators and other high frequency indicators suggest that Europe and Japan will slow a tad. Forward-looking indicators we have developed to track future export demand for Asia are also pointing to weaker growth in Asian exports. More than that, a measure of global liquidity we follow is now declining for the first time in almost a decade, a bad sign for asset prices in emerging markets which suggest more wild swings in emerging market currencies, equities and bonds.

But the big swing factor in the world economy is China, so we should focus on that. Here there is ample reason to worry because the key engines of growth are slowing:

- **Investment at risk:** Fixed asset investment which is China's most important growth engine is decelerating sharply, growth in July was the slowest ever recorded. This is a big worry because investment accounts for more than 40% of the economy.

- **Consumer demand is flagging as well**. In July, we saw retail sales growing more slowly. More worryingly, consumer confidence has taken a beating in August, according to the Financial Times survey.

However, policy makers in China have recognised the risks and are easing policy, stepping up infrastructure spending and easing a little on monetary conditions. But unlike in previous periods of a slowing economy, their room for manoeuvre is constrained by the build-up of debt in the economy and their own fears that easing policy to support growth could easily lead to even more debt which could destabilise the economy in future. This is particularly the case because the past few weeks have seen more evidence of financial stresses escalating, from the collapse of peer-to-peer lending platforms to a near default by a state enterprise to a rise in non-performing loans.

Clearly, we are at a stage in China where even policy makers as astute as China's will struggle to get the exact balance right in this context: China is a growing risk for the world economy.

US: the Trump presidency is in danger

President Trump has suffered a series of setbacks in the past two weeks. His former lawyer, Michael Cohen, appears to be working out a deal with prosecutors to avoid a long prison sentence for various financial offences. In his court appearance, Cohen seemed to suggest that President Trump had instructed him to make payments which may be deemed illegal under campaign financing laws. Two other key associates who are also facing possible criminal charges have been given immunity, presumably in exchange for information which may hurt Trump directly or indirectly. Even for a Teflon-coated president like Trump, these developments pose serious threats which could undermine his presidency and perhaps even lead to criminal charges in future.

There is one reason why this matters to the rest of the world – a president under siege from his domestic opponents may well feel he has to create an international distraction in order to deflect attention from his problems and to rally the people around him. This is where trade tensions and other geo-political risks come to the fore.

Trade frictions will get worse in the near term

Some observers have taken heart from the decision by the United States and Mexico to reach a new agreement on their trading relationship. Certainly, this is good news and we may well see this agreement broadened out to include Canada in a revised North American Free Trade Agreement. However, other developments on the trade front have been worrying.

First, there was no meeting of minds during talks between the United States and China over their trade disputes. There is now an increasing possibility that the American administration will go ahead with tariffs on a further USD200 billion worth of Chinese exports to the United States. That would be on top of the USD50 billion which are already subject to higher tariffs.

Second, we also think it likely that President Trump will go ahead with tariffs on automobiles, something that is sure to anger close American allies such as Canada, Europe and Japan as well as China.

In short, there is going to be more uncertainty for businesses as trade tensions grow.

Geo-political flashpoints – watch Iran

President Trump has clearly shown his distaste for the Iranian regime by pulling America out of the multilateral deal with Iran that persuaded it to give up its nuclear programme. Tough American sanctions on Iran have come into force with more following in the coming months. Already, Iran's oil exports have plunged in the first half of August and are set to fall further in the coming months. Even China and India which dislike bowing to American pressure, have chosen to cut back imports of Iran oil rather than risk their relations with the United States.

As a result, prices of the benchmark Brent crude which have already risen 43% over the past 12 months could move up further. That would take them to a level that would damage many emerging economies such as India which depend on oil imports: their economic growth would slow, inflation would rise and their current account deficits deepen.

Implications for Asia

There is more we can say of other geo-political and economic risks but the basic picture is clear: the world is not going to be a safe place for emerging Asian economies:

- Slower global demand for manufactured exports will mean some loss of economic growth momentum over the next few quarters. Outside oil, there could be downward pressures on other commodity prices as a result.

- The respite from equity market falls and currency sell-downs is not likely to last. As the environment turns more difficult as described above, the weaker emerging economies will come under more severe pressure. Countries such as Turkey and Argentina which have been forced to jack up rates massively to defend their currencies will probably suffer recessions and rising financial stresses such as non-performing loans. In another round of emerging market corrections, Asian currencies and equity markets will certainly also fall as well.

Basically, Asian policy makers will have to be innovative in how to buffer their economies against these external headwinds because they will not be able to use traditional monetary and fiscal policy tools as easily as before.

First, there are constraints on using monetary policy. Far from being able to cut rates, central banks in our region have had to build credibility with financial markets by raising rates to defend their currencies. Indonesia's central bank, for instance, was pro-active in raising rates aggressively and early. This has boosted its credibility with financial markets, providing the country with some insulation – but higher rates will slow the economy to some extent.

Second, stepping up fiscal spending might be one way forward but even this is proving difficult since investors are monitoring how rigorously countries manage their public finances as well. Indonesia is again an example of this – its proposed budget for 2019 was cautious and conservative. One option might be to make way for more private-public partnerships to promote more infrastructure spending so that the fiscal constraint does not hold back construction of roads, railways, ports and power stations. Another way might be to relax macro-prudential restrictions on lending and the real estate sector to provide some relief to economies.

Third, it may well be that the region will have to focus on longer term structural reforms to support their economies. More deregulation to improve the ease of doing business is likely. On the trade front, countries should move ahead on multilateral trade deals such as the Regional Comprehensive Economic Partnership or RCEP. RCEP negotiations have been bogged down by differences among the negotiating countries. The time has probably come for the majority of countries in the RCEP process to move ahead, if necessary without the countries that are holding up progress.

In short, the region is likely to face greater headwinds and occasional financial stresses. Asian policy makers have to be prepared for a more difficult period and must think out of the box to insulate their economies against these challenges.

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