ARTICLE FOR THE EDGE

THE GLOBAL ECONOMY: GET READY FOR MORE BAD NEWS

The gods have been conspiring against the world economy where nothing seems to be going right. Economic activity is losing vitality virtually everywhere – even the seemingly unstoppable American economy is slowing. Tensions between the US and China are escalating. And this has not stopped the US from ramping up trade aggression even against friendly nations such as Malaysia and Singapore or potential strategic allies such as India.

How bad will things get and what will the impact be on regional economies?

In short, our view is that economic conditions are likely to deteriorate further. Financial markets seem to think that monetary easing will prevent the slowdown from turning into a downward spiral. That could be true but only up to a point. There are some fundamental unknowns – how the US and China conduct their relations, how convinced businesses across the globe are that the downside risks can be contained, and whether the slower global economy might trigger financial imbalances in China and elsewhere. Until there is clarity on these factors, the downside risks will grow.

What has gone wrong?

The news flow in the past two weeks has been unremittingly depressing.

First, it is clear that the slowdown in global economic activity is much worse than most of us thought. The latest purchasing manager indices (PMIs) show sharp contractions in manufacturing activity across all the major economies. The global manufacturing PMI fell to 49.8 in May from 50.4 in April, registering its lowest level since October 2012. Business sentiments and the state of new orders all point to continued contraction in manufacturing around the world. Even the phenomenal American jobs machine seems to be sputtering, as private sector job creation slowed significantly in May. Korean exports – a bellwether for export performance in other Asian countries as it is released earlier – are falling sharply, dragged down by a precipitous fall in demand in China, not a good sign for how the world's second largest economy is doing. The fall in Hong Kong's PMI to its lowest level in three years also reflects the troubled state of the Chinese economy.

Second, China's economy remains fragile. The authorities have been forced to step in and take over a small bank, Baoshang Bank, because of what the regulators said was the "severe credit risk" that the bank posed. Following that, speculation is swirling over how many other such banks could be in trouble. Some bank analysts have pointed to the rising number of banks in China which have delayed reporting their financial statements for the first quarter while others have also named some which have seen auditors resign suddenly, an indicator of serious problems in those banks. If, in this precarious time for banks, the economy slows sharply and causes cash flows of borrowers to fall, then non-performing loans will rise and more banks could be in jeopardy. That could send the economy into a tailspin.

Third, frictions between China and the US have escalated: China is now openly talking about hitting back against the US by restricting exports of vitally needed rare earth metals and of drawing up a list of "unreliable" foreign firms operating in China. The Chinese authorities observed that this list would include "foreign legal persons, other organisations or individuals" who are suspected of "damaging the legitimate rights and interest of Chinese companies and jeopardised China's national security and interests". That's a clear sign that American companies – who have more than USD150bn of sales in China – could be targeted. China has already initiated an investigation into Fed Ex after it mis-routed packages that were meant to be delivered to China's telecommunications giant, Huawei.

Fourth, the dislocation from the trade wars is now becoming more tangible and could compound the global slowdown. Large companies with extensive supply chains seem to be reaching the conclusion that they can no longer wait to see if somehow China and the US might pull off a trade deal. Fearful of tariffs and other aggressive economic measures, companies have started to re-jig their supply chains. Exporters to the US are sieving out producers in China so as to reduce the risks to them from tariffs and other possible sanctions. The latest data on capital spending by businesses in the large economies show that firms are also delaying or cancelling capacity expansion.

The fundamentals are against us – the near term prospects are therefore worrying

To fully understand how things are moving, we need to go beyond these details and appreciate the geo-political context in which they are unfolding.

Our deepening pessimism stems from the realisation that we are living in a world where three big powers – the US, China and Russia – are vandalising the diplomatic, security and trade frameworks that helped preserve political stability and allowed the Asia-Pacific economies to flourish. This sounds like a strong statement to make but it is not an exaggeration. The current American administration has broken basic norms of diplomatic conduct and has few qualms about undermining vitally important international frameworks such as the World Trade Organisation's dispute settlement mechanism. China is not innocent either, witness its occupation of disputed territories in the South China Sea, its refusal to accept the findings of the International Tribunal of the Law of the Sea, its efforts to force technology transfer from foreign companies to local ones and its intimidation tactics against countries that annoyed it. Russia's interventions in Georgia in 2008 and Ukraine in 2014 did not do the global order any favours either.

And this is why, although there are some offsetting trends, they are not enough to for us to be confident of future prospects. Yes, financial conditions have loosened for the developed economies – for example, 10-year US bonds yields have fallen sharply, from 2.55% at the beginning of May to 2.13% this week. Falling borrowing costs should help firms and consumers, while also probably boosting housing demand. And, yes, another positive has been the correction in oil prices, which have fallen by around 15% since early May. But, these changes are unfortunately too modest to change the overall picture of a downward drift in global prospects. Financial markets are therefore celebrating these positives too prematurely.

What should we expect in the coming weeks and months?

- There will be more signs of a weaker economy and its knock-on effects on our region. Export growth is likely to flounder and, as a result, consumers and businesses will tend to cut back on spending, weakening our economies further.

- China and the US will engage in more pushing and shoving. China's strategy seems to be to demonstrate to the US that it can inflict pain on the US as well so as to persuade the Trump Administration to back away from its uncompromising demands. China is probably not going to return to the negotiating table until it has made its point. Eventually, there will be some kind of trade deal since it is in both sides' interests to avoid a damaging downward spiral in the global economy. But that will take time.

- Policy makers in the big economies will step up their efforts to counter the gathering slowdown. In the US, Federal Reserve Bank officials including Chairman Powell have made it clear that they will cut rates if the economy weakens. Given the very serious downside risks in China, China needs to aggressively ease credit restrictions, expand the fiscal stimulus substantially and loosen some of the administrative restrictions in areas such as the property market.

What about Southeast Asia, what can it do?

This region is highly dependent on the world economy, whether it is through exports or commodity prices or tourist arrivals or capital inflows to finance current account deficits or the foreign direct investment that is essential to economic development. As the global economy deteriorates, the downward pressures will build on regional economies.

At one level, we need more pro-active domestic counter-cyclical policies. In the past year, the emphasis was more on stability rather than preserving growth. For instance, Bank Indonesia raised interest rates aggressively in order to protect its currency even at the risk of slowing the economy. Similarly for the Philippines. That was the right thing to do then. But now, with the headwinds growing, the priority needs to shift to preserving growth by easing both monetary and fiscal policies.

Beyond such immediate responses, there is also a need for more strategic, long term responses to prepare the regional economies to face down what could be a permanently stressed global economy. Domestically, this means stepping up infrastructure spending so as to boost demand and reduce a constraint on competitiveness. There should also be more reforms of the supply side of the economy. For instance, if Indonesia deregulated its labour market rules to make them more investor-friendly, that would attract a lot more foreign investment in export-oriented manufacturing which Indonesia needs.

But we also need a more coordinated regional response.

- If ASEAN spoke with one collective voice on issues such as trade protectionism, it would protect the regional economies a lot more than if each country tried to stand up to protectionist pressures individually.

- Monetary and fiscal policy easing would also enjoy more credibility in financial markets if they were coordinated.

- Given the likelihood of more financial market turbulence hurting currencies and balance of payments, ASEAN should work harder at creating its own regional safety nets. Currently, the regional countries would have to turn to the International Monetary Fund for financial support in the event of currency or balance of payments stresses – but the Asian financial crisis of 1997-98 made countries wary of the IMF. Or they can turn to the Chiang Mai Initiative – but as China, Japan and South Korea are its main funders, the ASEAN nations would need their approval to secure funding. It is time ASEAN built its own fund to protect itself from an external crisis.

- Finally, at a time when globalisation is in retreat, there is an even more pressing need to reinvigorate ASEAN economic integration. While initiatives such as the ASEAN Economic

Community have made some progress, it falls far short of the integration needed to offset the slower growth of world trade and investment.

The bottom line

The region is facing a much more troubled world and it needs to step up its adjustment to that reality.

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