ARTICLE FOR THE EDGE

SOUTHEAST ASIAN OUTLOOK: RISING CYCLICAL RISKS, EXPANDING STRUCTURAL UPSIDE

The global economy is being pulled and pushed in different directions. Whether it is America's trade spat with China or the fragility of China's economy or the geo-political stresses in the Middle East which are raising oil prices, the ups and downs of the news flow make it hard to discern the net impact. However, a close study of recent developments shows two opposing trends - the region will be hit hard by cyclical forces but the structural prospects over the longer term are improving to the point where a new development surge is likely in ASEAN.

The economic cycle: things can only get worse

The bad news we discussed a month ago has worsened. The past week has seen a flurry of economic data which leaves little doubt that the global slowdown will persist. Global manufacturing activity as measured by purchasing manager surveys has fallen to its weakest level since 2012. Across developed economies there is a consistent pattern of a dwindling pipeline of new business for manufacturers while business optimism has plunged to its worst ever level in the survey's history: that means that things will get worse. Although services sectors in the US, Europe and Japan show continued expansion, there are several reasons why the outlook is for a worsening of economic conditions.

First, surveys of companies across developed economies reveal growing apprehensions in the business sector over trade tensions and geo-political risks. As a result, managers are taking on a defensive posture, warily cutting back on spending, minimising new hires and deferring capacity expansions. The slight thaw in US-China tensions will not be enough to improve their confidence. After all, with both sides playing tough and being prepared to walk away from talks from time to time, no one should expect a swift resolution of the more contentious issues in these negotiations. Moreover, American protectionist actions have continued: just in the past few days we have seen the US imposing further tariffs on European exports while also targeting Vietnamese steel exports. There has also been a steady drumbeat of American grousing over so-called currency manipulation by Europe, Japan and even countries in the region such as Vietnam.

Thus, businesses around the world know that protectionism will get worse but they do not know precisely which countries and which sectors will be affected. That uncertainty will restrain spending and slow the world economy.

Second, China's economy continues to struggle and the impact is increasingly being felt on the region. Growth in industrial production fell to a 17-year low in May while the pace of fixed asset investment eased again in May despite policy makers' efforts to stimulate capital spending. The early data for June such as the purchasing manager indices showed no signs of improvement. At the same time, financial stresses are growing. The failure of a small city bank has undermined the ability of smaller banks' to raise desperately needed wholesale funding. Separately, the default of a trust company has focused concerns over stresses in the CNY7.9tn market for wealth management products in China. A few days ago, it emerged that an investment company owned by the Qinghai provincial government was struggling to repay its loans. We still believe that the government's increasingly vigorous stimulus efforts will help maintain economic growth – but the economy's tardy response to the government's support measures tells us clearly that the headwinds in the economy were far worse than policy makers had expected.

China's economic difficulties are already impacting the region. Taiwan's manufacturers have reported a sharp decline 13.9% in export orders from China in May and the same pattern can be seen in other East Asian economies such as South Korea whose exports to China plunged by 24% in June. Another key Chinese contributor to global growth - Chinese tourist spending abroad - declined by around 10% in the first quarter this year compared to last year. This is one reason why Vietnam and Thailand's tourist arrivals have been declining this year. As the economy loses momentum, we can also expect the Chinese authorities to become less generous in how it finances its Belt & Road Initiative, another important channel through which China affects the world economy: Chinese investments in African infrastructure programmes are reported to be under greater scrutiny now, for instance, and disbursements have slowed.

A third driver of the region's fortunes is the electronics cycle, as the production of electronic components plays a large role in manufacturing sectors across east and southeast Asia. Electronics demand had been under pressure for several quarters due to an overhang of excess inventories, but this had been expected to reverse in late 2019. That recovery will now be delayed. Wary businesses are not in a mood to invest in new equipment, which puts a dampener on the demand for the electronic parts that modern machines are made from. America's technology war on China may also be delaying the roll-out of 5G telecommunications networks which had been forecast to drive electronics demand. And now, we have the dispute between Japan and South Korea which has resulted in Japan limiting exports of vital electronic components to South Korean technology firms.

Clearly, global trade will not be a positive driver of regional exports. Indeed, the World Trade Organisation's latest lead indicator for global trade conditions was discouraging.

Other lead indicators are equally disheartening – the OECD’s composite lead indicator is at its lowest level in almost 10 years.

The region will therefore have to depend on its domestic engines of growth. Fortunately, now that general elections in Thailand, presidential and parliamentary elections in Indonesia and mid-term congressional elections in the Philippines are out of the way, there is more clarity on political stability and policy making. Some pent-up spending will now be released as a result. At the policy level, governments will respond by cutting interest rates and stepping up fiscal spending. Administrative restrictions on credit extension and in the property market could be toned down as well. All these can mitigate the effects of the global slowdown but cannot offset them entirely. The region’s economic growth will thus slow in the coming year to year and a half.

Production relocation and higher foreign investment are promising signs for the future

The good news is that, if we look beyond the region’s immediate economic outlook and focus on the longer term trends, there are more reasons than before to be optimistic.

Trade wars are never good but there are some silver linings. One is that the relocation of production out of China to other developing economies that began a few years ago is accelerating. Originally a result of economic factors such as rising costs in China and a stronger Chinese Yuan, global corporations as well as Chinese companies themselves are stepping up this relocation now that Chinese-made goods are certainly more at risk of protectionism.

In a recent survey by the American Chamber of Commerce in China (AmCham), 28% of firms reported that they were thinking of moving production out of China – almost double the 15% that said so in October last year. Around 11% of firms were prepared to consider exiting China entirely, more than twice the 5% figure observed in last October’s survey. A separate study of Korean companies also revealed a changing attitude to China, with more than half of survey respondents talking about reducing their manufacturing activities in China. Where Korean companies have shifted out of China to another developing country, it has been typically Vietnam that they have moved to.

And the big winner from this trend – Southeast Asia: An astounding 88% of respondents to the AmCham survey observed that Southeast Asia was a more or equally attractive place to do business compared with other regions. This figure was an improvement on the already impressive 75% who thought like this in the October 2018 survey. There are also media reports that Apple has requested its main suppliers to assess the viability of moving 15%-30% of their production capacity from China to Southeast Asia.

The result is that in 2018 Southeast Asia seized a larger share of foreign direct investment flowing to developing economies than China, for the first time since the halcyon days of Southeast Asia's economic boom that was ended by the 1997 financial crisis. Even better still, the upsurge in approvals of foreign direct investment in the region in the first quarter of this year suggest that this trend will continue. Malaysia has seen a big rise but Vietnam is still doing well. Interestingly, even the Philippines, long a laggard, has seen an uptick in foreign investment.

Southeast Asia's attractiveness to foreign investment should rise further

Ultimately, a country's or region's economic performance is underpinned by the capacity to deliver superior returns on capital invested while reducing the risks of investment. Thus, the fact that several Southeast Asian countries are now generating higher rates of return on capital to foreign investors than China marks a critical change in the region's prospects. For example, while the rate of return in China has fallen steadily in the last 10 years, Indonesia's has risen and now exceeds China's.

The question is whether this trend can be sustained. There are three big reasons why this is possible.

- First, the infrastructure constraint on Southeast Asia's growth is being addressed. In both Indonesia and the Philippines – two countries that had substantially under-invested in roads, ports, airports, power generation and mass transit for decades – public spending on infrastructure has risen by 1-2 percentage points of GDP in the past 2 years. And that is just the beginning – many large projects are just now being launched. Thailand is also stepping up construction of roads, railways and agricultural infrastructure. Better infrastructure reduces logistics costs and opens up new business opportunities – and all that translates into higher returns.

- Second, expanding supply-side reforms should create an eco-system in which companies can earn higher returns. Since President Joko Widodo came to power in Indonesia, deregulation efforts have allowed his country to leap up the rankings of the World Bank's Ease of Doing Business study. The Philippines – a place many foreign investors find difficult to operate in - is also undertaking reforms while also improving internal competition that can reduce business costs. If President Joko will actually bite the bullet on labour market reforms as he has hinted, it would be a huge game-changer, potentially turning Indonesia into a major destination for foreign investment.

A third reason is the benefits of regional and trade integration. Four ASEAN countries – Brunei, Malaysia, Singapore and Vietnam – have joined the Comprehensive and Progressive Trans-Pacific Partnership, giving them better access to large and growing markets than their competitors. The ASEAN Economic Community has been implemented and its benefits are accruing – too slowly for some but the trend is in the right direction. The Greater Mekong Sub-Region has been a great success in regional integration initiatives and has been a boon to the countries of continental Southeast Asia. As more roads, railways, power grids and air connections link the region together through improved connectivity, even more synergies can be expected.

Conclusion: the region could again become a pre-eminent growth pole in the world economy

The near term prospects are indeed of great concern but with adequate fiscal and monetary policy actions, the worst can be avoided. The region needs to convert the current travails into an opportunity. Sustained efforts at continuing the positive trends in infrastructure, supply-side reforms and regional integration can result in the whole region surging ahead, enjoying much higher economic growth and returning the region to the glory days of the early 1990s when the region was booming.

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