

ARTICLE FOR THE EDGE

A GLOBAL RECOVERY IS UNDERWAY BUT HOW MUCH WILL IT BENEFIT ASIA?

Newspaper headlines continue to highlight how the COVID-19 pandemic is still raging and the mayhem it is causing. These concerns about the pandemic have led many institutions, such as the Asian Development Bank, to issue decidedly downbeat forecasts for the world economy, thus adding to the gloom. But this pessimism might be overdone. After all, there are several lead indicators that point to a decent recovery in the big economies that essentially determine where the global economy is heading. Moreover, we find that the forces that are shaping this recovery are durable. Even with this recovery though, Asia faces some headwinds. In particular, recovering demand in large economies may not translate into stronger Asian exports because the appetite for foreign goods in those countries seems to be falling. And that means that governments in Asia still need to maintain policy support to ensure that the recovery is sustained.

Lead indicators speak of a global recovery, which underlying forces can sustain

The OECD's lead indicators (LIs) have a credible track record in predicting the course of the economic cycle. So, it is encouraging to see the latest batch of OECD LI indicators foretelling an uptick in the world economy. The overall composite lead indicator rose in July with almost every developed country and major emerging economy recording higher LIs. Moreover, surveys of purchasing managers show order books swelling again among the world's manufacturers, meaning that higher production is on the way. The various member banks of the US Federal Reserve Bank are predicting annualised expansion of third quarter US economic output to be anywhere between 15% and 30%, after the 32% slump in the second quarter. These same agencies see the rebound continuing at a slower but still healthy pace in the final quarter of the year.

Digging deeper, we find that the main determinants of global economic activity are looking healthier.

First, the damage caused by the pandemic on economic activity is lessening, despite all the scary headlines. One reason is that governments are wary of responding to spikes in infections by imposing stringent lockdowns that crush activity. So, while renewed infections in parts of the United States and Europe have stoked fears that the recovery will stall, we find that the governments' restrictions on activity are much more targeted and of limited duration. Another factor is that the disease is becoming less scary to consumers because better drug treatments and improved clinical management have reduced fatalities and the damage the disease causes to victims. Thus, consumers, while still wary, have tempered their caution and continue to keep the recovery in spending going. Governments, public health experts, businesses and ordinary folks are coming to terms with the COVID-19 pandemic and learning to adjust to it: there is simply no appetite for long-lasting and severe restrictions on activity.

Second, government policy has continued to be highly supportive of economic activity. In the monetary arena, central banks' monetary operations are proving to be more effective in developed economies than during the global financial crisis a decade ago. Indeed, the US Federal Reserve Bank has signalled it will be aggressively supporting the economy. Also, unlike in the financial crisis, the expansion in central bank balance sheets is translating into growth in broad money which is what will support future economic activity – i.e., monetary policy is much more effective than before. In China, the credit impulse is strong as well – not as powerful as in 2008, but clearly enough to bolster the economy.

Fiscal policy measures are now being toned down in some economies as they recover. But in most cases, governments are still finding ways to undergird demand. Unconventional measures to protect the economy during the pandemic continue – such as government guarantee schemes to encourage banks to continue lending to small businesses and various measures to protect employment. For example, the German government will extend its wage support programme through to the end of 2021 while in France, the new prime minister has proposed a massive spending plan to keep the recovery going.

The main risk is in the US where political gridlock has scuppered the chances of another set of fiscal support measures. However, even here, we expect an eventual compromise since it is not in the interest of either the ruling party nor the opposition to risk a sharp loss of economic momentum just before the presidential and congressional elections.

Third, although still below the pre-pandemic level, business investment is begging to gain traction again. In the US, core capital goods orders, jumped 4.3% in June and rose another 1.9% in July. Core machinery orders in Japan have also started edging up. In China, fixed asset investment registered its first year-on-year growth since the pandemic, up 0.3% in January–August compared to –1.9% in January–July. Going forward, spending on technology will be key to business capital spending. We might see some deceleration in tech spending in coming months as large companies appear to have purchased sufficient memory chips and the semiconductor giants are pausing capacity expansion in response. However, we see a renewed push in technology as companies build data centres and the 5G rollout (interrupted somewhat by the US–China tech war) resumes. We also see green shoots in the outlook for consumer spending on tech gadgets such as smartphones and gaming consoles in the holiday season. Tech companies are also reporting that demand for work-from-home equipment which they had expected to be short-lived is proving to be more durable.

The challenge for Asia: demand in major markets is becoming less import-intensive

Despite the improvement in the world economy, the demand for Asian exports does not seem to be improving as quickly. The purchasing manager surveys show new export orders continuing to decline in virtually every Asian economy we monitor except China and Taiwan. In some cases, such as Indonesia and Thailand, the falls are strikingly sharp.

One reason is the declining appetite for imports in the big markets. Since 2014, we have noticed a fall in the share of imports in global GDP: in other words, as the world recovered

from the financial crisis, import demand did not keep pace with the expansion of the economies. It is a bit of a mixed bag when we look at the factors that shape import demand in future:

- First, growing protectionism. The World Trade Organisation has noted that the share of global imports affected by proliferating trade-restrictive measures has grown steadily. The worsening trade frictions between the US and China have compounded this problem. More generally, the COVID-19 pandemic seems to have persuaded policy makers in large economies such as the US, China, Europe and Japan to pursue more inward looking policies which will discourage the growth of imports.
- Second, related to this, China has expanded its capacity to produce intermediate goods such as electronics components that it used to import. Thus, its propensity to import has diminished in the past decade or so. This trend is not likely to reverse. If anything, some of China's plans for manufacturing seek to displace imports in key areas such as semiconductors. Other Asian exporters will be losers from this trend.
- Third, the phenomenal surge in Chinese demand for raw materials that started when China joined the World Trade Organisation and continued with its massive stimulus programme in 2008, has faded. But this could change. China seems to be on the cusp of another big infrastructure push. Its plans for the post-COVID era include spending on new urbanisation (creating clusters of urban areas and replacing slums with brand new homes) and new infrastructure (such as ultra-high voltage electricity grids and electric vehicle charging stations). Beijing has pressed local governments to accelerate their bond issuance to fund such infrastructure spending which we expect to take off soon. That surge in spending should boost demand for iron ore, coking coal, copper and other base metals. Sure enough, prices of copper and iron ore have surged.
- Fourth, supply chains are being reconfigured, with mixed effects on our region. At one level, production will continue to be relocated out of China and Southeast Asia should remain a major beneficiary of that trend. But in some areas, we are seeing a re-shoring of production whereby production is returned to a developed economy rather than to a lower-cost emerging economy. For example, about USD38 billion worth of investment in manufacturing facilities is flowing back to Taiwan from China this year. Japan's programme to encourage its firms to shift manufacturing from China back home has gained traction - the second phase of that programme is reported to have attracted much larger support than the earlier phase. We have also noticed in other instances that global manufacturing firms are "near-shoring" production, i.e., relocating production out of China to low-cost centres close to their home countries such as in Mexico, Turkey or Morocco - not to other Asian countries.

Conclusion: what are the implications for our economies and what should they do?

In short, a global economic rebound is likely and it may well be much better than expected.

But that turnaround may not benefit Asian exporters as much as before. The bounce in natural resource prices will be mainly in commodities such as coal, iron ore, copper, nickel and so on which do not benefit Southeast Asian economies whose commodity exports are more in areas such as crude palm oil, rice and rubber. The region's exports of manufactured exports should enjoy some improvement but will face some headwinds as well for all the reasons discussed above.

Two implications follow from this conclusion.

First, since exports are not likely to give a strong and quick fillip to growth, governments must ensure that supportive monetary, fiscal and other measures must continue. A premature withdrawal of policy support could be very damaging. It is best to err on the cautious side even if there is some risk to the fiscal position.

Second, longer term strategies are needed to promote the region's exports since exports of manufactured goods are likely to be still needed to advance economic development goals:

- One area has to be regional economic integration. After the huge effort that went into securing the Comprehensive and Progressive Trans-Pacific Partnership and in finalizing the Regional Comprehensive Economic Partnership, there is a risk that diplomatic fatigue will deter governments from further efforts at regional integration. There should, for example, be a greater effort to improve how the ASEAN Economic Community (AEC) actually functions, so that the promised trade liberalisation materialises. The AEC has technically been in place for five years now but the benefits have yet to flow in material amounts.
- The region also has to do more to improve its own competitiveness as an exporting region. Here there is progress. The huge infrastructure push of the past few years as well as the vigorous efforts across the region to cut red tape and improve the business eco-system will translate over time into lower production costs and quicker turnaround times. It should also help attract more foreign direct investment into the region's manufacturing sector.

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