ARTICLE FOR THE EDGE

CHINA-RELATED RISKS HANG OVER SOUTHEAST ASIA

China's rise gives it a greater footprint on the world economy. Whenever something happens there, the rest of the world feels its impact much more than before. This is especially the case in Southeast Asia which is part of China's hinterland. So, when three big developments are underway simultaneously - a slowing economy, a major shift in policy and ideology and a worsening relationship with the US - then our region needs to sit up and prepare for the implications: China today poses more complex risks for the region and how these pan out depends on answers to three questions discussed below.

1. Will China's economic slowdown get much worse?

There is little doubt that China's economy has lost momentum recently but what is not clear is how deep or persistent this weakening is.

The recent data has been a tad more disappointing than expected. Industrial production growth has decelerated to just 5.3% in August from 6.4% in July, its weakest pace since July last year. Fixed asset investment - a major driver of China's growth - is barely growing with some analysts estimating that it contracted in July and barely grew in August. Moreover, the rapid rise in producer prices has not been matched by an equivalent pace of increases in consumer prices - that could mean that firms' profit margins are being squeezed and that in turn could depress investment intentions further. With retail sales expanding at the slowest rate in 12 months, it looks like consumer spending, another major force behind China's economy, is also sputtering. That leaves exports - still growing very strongly - as the only vibrant source of growth in China.

Yet, despite the numbers, there are a number of reasons why it is premature to ring alarm bells on China's economy:

- First, there is a lot of noise in the data, and that should caution us against drawing strong conclusions about the economy. In recent weeks, China has endured major bouts of bad weather that have disrupted business operations, a troubling spike in COVID infections which led to wide-ranging restrictions on economic activity, significant disruptions in shipping at some ports and shortages of important intermediate goods such as semiconductors. As these one-off factors dissipate, the economy should bounce back.

- Second, one reason for slower growth is government actions which can always be rescinded if the impact turns out to be worse than policy makers are prepared to tolerate. For example, the authorities have been limiting the operations of manufacturing plants which cause pollution so as to ensure blue skies during the Winter Olympics early next year. Local governments have been under pressure from the central government to step up their decarbonisation efforts as well, leading to sudden and sometimes quite arbitrary orders for businesses to scale down operations. For example, the authorities in Yunnan province recently instructed smelters to cut aluminium production by 30% for the rest of this year so as to achieve targets for reducing energy use and greenhouse gas emissions. The government has also been keen on reducing financial risks in the economy, leading to measures to rein in credit growth and to cool housing markets in many localities. In contrast to these actions which dampen growth, policy makers have been providing targeted support to selected sectors so as to keep growth on track. They have the means to step this up if growth falters.

- Third, the fundamental drivers of the economy remain in decent shape. Take consumer spending first. Unemployment has fallen and net job creation has been vigorous. People have little reason to cut back on spending. It is therefore possible that the sluggishness in consumption could be a result of other factors. For instance, slower car sales are partly caused by shortages of automotive chips which reduced auto production, leaving fewer cars available to be sold. The downside risk to consumer spending would, however, grow if the authorities fail to contain the current outbreak of COVID infections and resort to far harsher restrictions on activities. Financing activity also points to stronger growth in time – credit flows have picked up while local government bond issuance was nearly CNY1 trillion in August – the largest monthly increase since September last year. Export growth continues to be strong, across the board.

Thus, for now, we are not downgrading our forecasts for China's growth this year. We still expect the economy to expand by around 5%-6% in the second half of the year – a disappointing third quarter should give way to a strong snap back in the fourth quarter. Given the high growth in the first half of the year, 2021 should end with around 8.2% growth in economic output. The Chinese economy is already well above its pre-pandemic level and has not suffered major permanent scars from the pandemic.

2. Will a more ideologically-driven government hurt the economy?

It is crystal clear that President Xi Jinping has instituted a comprehensive ideological re-orientation of policy making in China. He is no longer prepared to passively accept some of the downsides of a free market economy as the unavoidable price to pay to secure a dynamic economy. From now on, the state will have a bigger role compared to the market in several areas.

Xi is aiming for "common prosperity" or an emphasis on a more equitable distribution of income than before. To achieve that, the state will regulate industries more vigorously to shape outcomes, not content to leave things to the market. Increased competition, for example, will be encouraged and monopolistic behaviour punished. In addition, the rich will be expected to "voluntarily" donate huge sums to charity.

Xi has also decried the "disorderly expansion of capital", referring to how large companies in the technology sector and elsewhere accumulated so much market power that they could disadvantage the interests of consumers and small businesses. So, state intervention will be stepped up in a hard-headed manner to put the business sector back in its place – even where massive wealth losses are inflicted on entrepreneurs, as we saw with the crushing of the tuition sector in the country. Some tech companies will have to allow state enterprises to take large stakes in their businesses.

Not content with these substantial changes, Xi has also made it clear that where social ills can be traced to the way companies or whole sectors operate, regulators will step in unapologetically. Hence, the restrictions on gaming for children and even a pushback against "effeminate" actors in the entertainment business.

Where else could Xi strike next?

- Remember that Xi has frequently emphasised that "housing is for living in, not for speculation". So the real estate sector could be targeted but we also think that the authorities will be careful about how they do this since they have already been cooling the sector for some time and they are fully aware that overdoing policy tightening could spark off a slowdown in the economy.

- But we should expect more action in other areas. For example, Xi wants strategically important sectors to develop faster so that China is less dependent on a hostile America for technology and critical components. Where policy makers think state enterprises can do this job better, we could see private businesses displaced.

- China is also likely to continue turning inwards. The "Made in China 2025" strategy and the notion of "dual circulation" (meaning a better balance between domestic demand and external influences) seem to point to China attempting to be more self-sufficient than before. That could mean a slower growth of imports.

There are two risks to the economy from this re-orientation. First, private businesses might cut back on investment since they are unsure about how far the government might go. Some may feel less secure about their property rights as well. Second, a heavier state hand in the economy could lead to misallocation of capital and other inefficiencies as we have seen over and over again in socialist economies. What can offset this is that China's technocrats are probably aware of these potential pitfalls, so we could see them providing reassurances to the private sector in coming months.

3. Could a further deterioration in US-China ties hurt the economy?

The answer is yes. Both sides are not communicating well with each other, and there is a risk of a breakdown of understanding. President Biden wants to get China to agree to a new relationship where there is a mix of cooperation and competition. But China is not prepared to engage the US in the way Biden seeks. It wants the US to agree to certain conditions first, addressing China's red lines in areas such as Taiwan, "interference" in its internal affairs and so on. But far from doing so, the US is strengthening relations with Taiwan and continuing to speak out vociferously on hot button issues such as China's treatment of its Uighur minority.

In the absence of a new understanding, each side could proceed with damaging actions. The US, for instance, is reported to be considering an investigation into China's use of industrial subsidies under section 301 of the 1974 Trade Act which could lead to another wave of protectionist measures. The anti-China hawks are likely to be emboldened by the continued worsening of relations and press for more restrictions on trade, technology and investment relations with China. This can only be negative for China's economy.

The bottom line – Southeast Asia must prepare for rougher times

The region should expect three implications arising from the above discussion.

First, while we should not dismiss the near term risk that slower growth in Chinese demand could slow the region's exports and depress commodity prices, we believe that a more likely scenario is of a Chinese economy that settles down to its trend rate of growth of around 5.5% – not as exciting as before but given its much larger size, still enough to generate good business for Southeast Asia.

Second, however, the ideological turn in economic policy could lead to a more insular China, less interested in allowing this region access to the more lucrative segments of its economy. Note that, over time, the growth in Southeast Asian exports of intermediate goods and components to China has slowed markedly. If a Chinese economy weighed down by the heavy hand of the state becomes less dynamic, then the region will also see fewer beneficial spillovers from China's growth.

Third, a tenser US-China relationship could also spell trouble for the region. Protectionists in the US may not be satisfied with just targeting China, they may well train their sights on countries in this region. Note that America's trade deficit continues to grow, not just with China but with most of its trading partners. This could spur more trade aggression in the US.

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