ARTICLE FOR THE EDGE

CAN SOUTHEAST ASIAN ECONOMIES REMAIN RESILIENT?

The International Monetary Fund (IMF) has just issued its latest World Economic Outlook, and it makes for a decidedly downbeat reading. Following the outbreak of war in Ukraine, the IMF revised global growth down for this year and next – it expects just 3.6% growth in world output for both 2022 and 2023, compared to its original forecast of 4.4% and 3.8% respectively. Not surprisingly, inflation is also seen to be higher, with emerging economies suffering more than advanced economies. To add to the gloom, the IMF emphasised that the risks were mostly to the downside.

What is striking is that, in the midst of this pessimism, the IMF had relatively less gloomy projections for Southeast Asian economies. While growth in the region is seen as taking a hit, the downward revision was just 0.3% point in 2022 and 0.1% percentage point in 2023. In short, the ASEAN economies are seen as suffering much less from the shocks in the global economy than other regions.

The big question for us is – will this resilience be sustained given the downside risks that the IMF and many others are rightly worried about? Our view is that five big factors will determine ASEAN's economic outlook. The first three are negative –the Ukraine war's impact; global monetary tightening led by the US Federal Reserve Bank; and China's unsteady prospects. But the other two are more supportive of ASEAN – the evolution of the covid pandemic to a more benign impact on economies and structural forces specific to the region which are likely to promote economic growth. Putting it altogether, we believe that ASEAN economies can indeed continue their relatively better performance compared to the rest of the world.

The Ukraine war's impact will be felt through multiple channels

How the crisis in Ukraine affects our economies depends crucially on how long the intense phase of the fighting will be and whether the violence spreads to neighbouring countries, making it a European, not just Ukrainian, war. Our assumption is that the risky phase of the war will last another few months before the fighting settles down into a stalemate. In other words, the phase when the chances of the war escalating and engulfing a larger region should end relatively soon. Assuming that the various protagonists behave rationally, direct military clashes between Russia and the western allies are unlikely. In the same vein, we also assume that the western allies will be selective in the use of further sanctions, avoiding actions that would hurt them as much as their rivals – such as a total ban on Russian exports of oil and gas or wielding sanctions broadly against countries such as China for aiding Russia.

In this scenario, we see elevated energy and food prices lasting several months more before easing by the end of the year, as supply improves and the risk of war disruptions also diminishes. But until then, businesses and consumers' spending power will be undermined and the uncertainty about how the war might spread will depress business confidence everywhere. Global demand for regional exports will be weakened but if the duration of the

risky phase of the war is as limited as we believe, then that damage to ASEAN economies will also be limited.

However, a lot can go wrong. We would have to watch, for example, if Russian forces are accused of committing such terrible atrocities that the ensuing revulsion is so strong that more extreme sanctions including a total ban on Russian oil and gas exports might be imposed. That is possible but it is not our baseline scenario.

Global monetary tightening is another headwind

Inflation has turned out to be much higher than anyone had forecast even six months ago. Many now fear a wage-price spiral that causes inflation to surge. Thus, central banks – and the US Federal Reserve Bank in particular – are seen as being behind the curve. The Fed, therefore, feels compelled to rebuild its credibility as an inflation-fighter by enacting swingeing rate hikes throughout this year and next. The Fed's policy rate is likely to reach 2.5%-3.0% by end-2023. The Fed will also be reversing its quantitative easing earlier and faster than markets had anticipated a few months ago.

Still, while monetary tightening is certainly a risk, it does not look as if the European Central Bank or the Bank of Japan will tighten as aggressively. In fact, China's central bank is moving in the opposite direction, stepping up monetary stimulus rather than reducing it. Thus, overall global monetary conditions will not tighten as drastically.

Economic activity in the US will decelerate as a result but, given the massive excess savings that have been built up in the household sector, the continued willingness of banks to extend consumer credit and tight labour markets sustaining strong demand for labour, we do not see consumer demand slowing so much that a recession becomes likely. Of course, higher policy rates are why mortgage rates are already up by more than one percentage point recently, and that will cause housing demand to cool and investment in real estate construction to slow. All in all, we think that overall the US should avoid a full-blown downturn. The more likely outcome is that economic growth slows to a pace closer to its potential growth.

China may be turning the corner but remains a worry for ASEAN

China's economy was already slowing even before the recent spike in covid infections led to stringent public health measures which have hurt the economy. Fortunately, with infections in Shanghai coming down, the authorities are allowing production to resume at hundreds of plants that were shut down and the worst seems to be over.

The central government is also stepping up measures to boost economic activity while government is also dialling back on policies which had damaged the economy:

- For instance, the authorities are likely to recalibrate their approach to pandemic management so that lockdowns and restrictions are more flexible and selective. In addition, the government is expanding its efforts to vaccinate segments of the population

which remain unprotected from the covid virus – older folks and rural people. The government will also be approving China's own version of mRNA vaccines which are seen as more effective. We suspect that these efforts will pave the way for China to reopen to the world before the year-end.

- We also see policy makers backing off some of the rectification measures they took to address structural problems in the economy. Vice-Premier Liu He has instructed the agencies concerned to be more careful in how far they go in imposing regulations on the technology sector.

- Finally, the measures to cool the real estate are also being implemented more selectively, with many local governments easing restrictions of late. In addition, rules brought in to reduce local government corruption are being tweaked so that they do not scare officials from making any decisions at all on contracts and projects. These policy changes suggest that the economy should begin improving in the third quarter.

Notwithstanding these positives, we still have some niggling doubts about China:

- First, there is opacity in the data which makes it difficult to get a good read on China's current conditions. For example, the official data show that economic activity in January-February was robust, with a slowdown only in March caused by the spike in infections. However, even China's official statistics bureau has sounded a note of caution in interpreting the January-February data, a hint that local officials may have inflated the numbers to make things look better than they were. The covid infection data show few infections in regions bordering Shanghai even though we know that thousands of Shanghainese left the city just before the lockdown. Given the high infections in Shanghai, many must have been infected, yet there is little in the official data to show rising infections in Shanghai's neighbouring areas.

- Second, while additional stimulus is indeed forthcoming, the measures seem incremental and the authorities appear reluctant to provide a more aggressive boost. Central government fiscal policy is still relatively tight and the authorities appear averse to policies that really energise the economy such as direct cash transfers to households.

- Third, while the government is refining those policy measures which unintentionally hurt economic activity, it may be a while before consumers, businesses and local officials actually change their behaviour. For example, the massive wealth destruction in China's tech sector will not be forgotten quickly, meaning that tech entrepreneurs in the damaged sectors are not going to go back to expansion mode in a hurry. Moreover, local officials will remain fearful that in the run-up to the 20th Party Congress later this year, the safest approach might be to avoid doing anything at all, instead of committing to contracts or projects that might turn out to be controversial later.

The positives – pandemic restrictions are easing and the region's fundamentals are good

We think that while these drags are real concerns, the easing of public health measures to tackle the pandemic will allow economic activity to return to normal. With fewer restrictions in place, manufacturing and transportation activities can resume. As dining, recreational and tourist activities are allowed again, there will be substantial release of pent-up demand. Supply side constraints such as the dearth of migrant workers can also be more easily overcome. All this will provide a powerful tonic to re-energise the economy, offsetting most of the damage caused by the negative forces described above.

More support for the regional economy will come from structural factors reflecting the region's improving fundamentals:

- We are confident that there will be more of the supply chain reconfiguration that will mean additional factories being relocated out of China and moved to Southeast Asia. Some of this is becoming evident in the foreign investment applications and approvals data. The ASEAN region's relatively more resilient economic performance should encourage further foreign investment interest in the region.

- After being distracted by the pandemic for two years, governments in the region are now looking to revive ambitious infrastructure plans from the past. This is particularly the case in Indonesia, the Philippines and Malaysia.

- The region is likely to enjoy more synergies from trade integration. The Regional Comprehensive Economic Partnership (RCEP) has now been ratified and is in effect. In addition, the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) has already been in effect since December 2018. More countries have expressed an interest in joining – China, Taiwan, South Korea, the United Kingdom and Ecuador have all filed formal applications to join. There is a chance that Thailand may also apply. Over time, the cuts in tariff rates and streamlining of customs and other trade facilitation measures should boost trade flows. Moreover, the increased trade connectivity will be yet another factor attracting foreign investment to the region.

Conclusion: so long as policy makers remain rigorous, the region will do well

In sum, despite a host of global challenges, the ASEAN region is in a good place. The remaining risk is of policy errors. That is why it is important that central banks continue to signal to markets that they will confront inflationary pressures forthrightly. It is also vital that economic managers in each ASEAN country continue to show commitment to the reforms that have improved the region's fundamentals.

Prepared by Manu Bhaskaran
CEO, Centennial Asia Advisors