Asia Back On Its Feet

After the last financial crisis, the region is seeing strong growth at last. Though threats to which it is vulnerable remain, it has been given a window of opportunity to complete structural reforms

■ By Steve Brice

GAUGING SENTIMENTS IN THE REGION is a much more positive experience than three months ago. There are three reasons for this increased optimism. First, stock markets have risen and property markets have returned to investors' radar screens in many economies. Even in Hong Kong, where property prices have fallen almost three-quarters since the onset of the Asian financial crisis, the market appears to be stabilising on prospects of an influx of investment from the mainland.

Secondly, buoyant asset markets are supporting consumer spending. It is also important to note the response to the latest SARS scare in both Singapore and Hong Kong. While they have obviously been headline news, they have not induced the panic that was typically associated with the outbreaks earlier this year. It appears people now have faith in the region's ability to deal with another outbreak more effectively.

Finally, the external environment has improved markedly in recent times. This is primarily due to stronger data coming out of the United States, and an increasing realisation that Japan is, at long last, delivering positive economic growth.

In this environment, we expect the trend for upward growth revisions to continue in the coming months. The International Monetary Fund (IMF), in its recent World Economic Outlook, revised up its growth forecasts for Developing Asia with ASEAN and India being the major beneficiaries. On our part, in the past month or so, we have revised up our forecasts for Thai, Indian and Hong Kong growth in 2004. Singapore and South Korea remain the exceptions to the rule as reaffirmed by disappointing August trade data in the former and continued weak consumer demand in the latter.

This optimism is being fanned by continued evidence of financial inflows to the region on the basis of undervalued asset prices and still artificially weak currencies. However, now is not the time to get carried away. Stock market rallies have been dramatic; at the very least, the pace of these gains is unsustainable even though on purely a price-earnings basis most stock markets in the region are still cheap relative to their western counterparts.

Three major risks facing the region

In our view, there are three major risks facing the region, in the areas of:

- external imbalances;
- reliance on investment demand; and
- politics

On the first, the focus falls on the US current account deficit. We believe a 5%+ deficit to GDP ratio is unsustainable. This can be corrected either by a weaker US dollar or a shift in relative growth rates between the US and the rest of the world.

With imports 50% larger than exports, exports have to grow 1.5 times the import growth just to hold the deficit steady. Unfortunately, export growth has been a fraction of import growth in recent times. Thus, the modest US Dollar decline seen so far is unlikely to make a dent in the deficit, especially given the stimulus to the economy via macroeconomic policy. This argues for further US Dollar weakness in the months ahead.

On the issue of relative growth rates, the structural weaknesses of the world's most sizeable economic regions outside the US, particularly Europe, mean any medium term rebalancing would have to come via sub-trend US growth. Although we are hopeful trend growth in Europe will improve as a result of recent structural reforms, we doubt this will be sufficient to deliver growth in excess of US trend growth of 3.0-3.5%.

With the US Dollar likely to weaken, matched eventually by weaker US growth (possibly after the US Presidential election), this suggests Asian countries should continue to promote domestic demand. The continued slow reform progress in the areas of corporate and banking sector reform, acutely evident in much of South East Asia, means the focus will eventually return to stimulatory fiscal and monetary policies wherever possible/necessary.

In the near term, Singapore may consider a further monetary easing in October following weak economic data. Meanwhile, South Korea announced it intends to stimulate a flagging economy via fiscal policy. As it heads towards the parliamentary elections, expect the government to continue pushing for an economic recovery. Elsewhere, the outlook for fiscal policy is mixed, with Hong Kong, the Philippines and Indonesia to return to fiscal consolidation in 2004 out of necessity while Thailand and Malaysia do so out of unexpectedly strong growth and choice respectively.

The final lever of macroeconomic policy remains in the international spotlight: exchange rate policy. The recent G7 communiqué highlighted its preference for major economies and regions to have flexible exchange rates to ensure a 'smooth and widespread' adjustment in the international financial system. Several inferences can be drawn from this. First, omission of mention of Asia explicitly does not change the fact the statement was directed at this region, in particular the major economies such as Japan and China.

Secondly, it highlights the desire for a gradual adjustment in exchange rates. This reinforces the fact that the US is unlikely to want a sharp adjustment in currencies, as this would risk sharply higher long-term interest rates as Asian Treasury holders realign their foreign exchange reserves away from the US dollar. This, in turn, would risk a recession, or at least much slower growth, in the US. Thus despite the rhetoric from the West, expect the Chinese authorities to be true to their word on no immediate shift in policy, especially not a dramatic one.

Thirdly, it implicitly increases the focus on Japan. As Japan recovers, the pressure is undoubtedly increasing on the authorities to allow the Japanese yen to appreciate. As Japan appears to have shifted its tolerance for the yen strength in recent times, this will put additional pressure on regional currencies to appreciate.

Finally, despite still being a developing economy with only a 3% share of world GDP, China has been promoted by the communiqué to 'major economy' status. This is apt given China's increasing influence in the world economy in volume terms – it has already become the largest single mobile phone market, is threatening to replace the US as the largest auto market, and is the largest contributor to the growth in demand for most basic and industrial commodities.

Reliance on investment demand worrying

This brings us neatly to the second risk; the region's reliance on investment. This has clearly been seen with the response of the region to the US business investment-led slowdown in 2001 and the sluggish recovery since. However, more recently, the region has become increasingly reliant on Chinese investment. Indeed, without such investment, the situation for Asia would have been much worse since 2001. But with investment in China reaching almost 40% of overall economic activity, this holds obvious risks, although there are no signs of this being an imminent problem.

The worst-case scenario is that the US economy slips into recession at the same time the Chinese investment bubble pops. Indeed, given that Chinese investment is increasingly reliant on mainly US multinational companies and these investments presumably rely on strong demand from the US, then such a scenario cannot be ruled out.

The good news is that if the US authorities can buy a little time, any economic weakness could be mitigated by a recovery in Japan and Europe. Meanwhile, China is focused on trying to spur consumer spending to reduce the country's reliance on investment spending. Given the mainland's increasing consumer wealth, as people move from West to East, this should be an ongoing trend, as evidenced by the continuing focus by value investors on consumer-related businesses in Asia.

Politics to come increasingly into focus

The final concern is the political outlook. The region faces numerous political events in the next 18 months. In Singapore, this merely reflects a handing over of the baton to another leader. In other countries, democratic elections are involved. In Malaysia, we have both.

Interest in political developments will be mixed. The Singapore and Malaysian transitions are unlikely to attract much international interest. Meanwhile, Thailand's election (at the turn of 2004/2005) is expected to return Prime Minister Thaksin Shinawatra with little problem.

Korea's parliamentary and Taiwan's presidential elections are likely to garner both domestic and international interest. For Taiwan, the key will be the prospects for relations with China. In Korea, local markets will be looking to see if the President's position is further undermined, while international markets will be focused on the implications of this for the North Korean negotiations.

At the other end of the spectrum are the Philippines and Indonesia. Here, we expect apathy to prevail, at least at the street level. This is because of the general view that no matter who wins the election, nothing really changes. However, local financial markets will be very sensitive to developments.

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In Indonesia, it is generally taken as a given that President Megawati Sukarnoputri will be returned to power. Anything that shakes that confidence would undermine domestic sentiment. In the Philippines, a good deal of confusion reigns over who will stand and what the implications of each potential candidate are. Here the risks are seen as greater.

In summary, the next six to 12 months look rosy as both domestic and international economies accelerate. But there are still imbalances in the world economy that Asia is vulnerable to. Therefore, we believe the challenge will be using this period of growth to push through with structural reform to ensure the domestic economy will be able to deal with the stiffer economic winds possible thereafter. ID

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