ANDBANK RESEARCH

Global Economics & Markets

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Asia – "The Shanquestration".
Cooling the economy to avoid a Western like collapse

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Recently we have witnessed a global economic and market destabilization. The "earthquake" had its epicenter in the U.S. (following the tapering of the Fed) but the aftershocks have been felt more violently in the emerging world (Asia and Latin America).

Assuming that Asia continues to contribute ¾ parts of the global growth, it makes sense to spend at least 3 quarters of our time of analysis to this region. So we did.

After being put our time series under strict scrutiny and having contrasted the work of independent research firms, we would like to summarize in this paper what we think are the main conclusions that we (and other analysts) have reached in reference to Asia.

Executive Summary

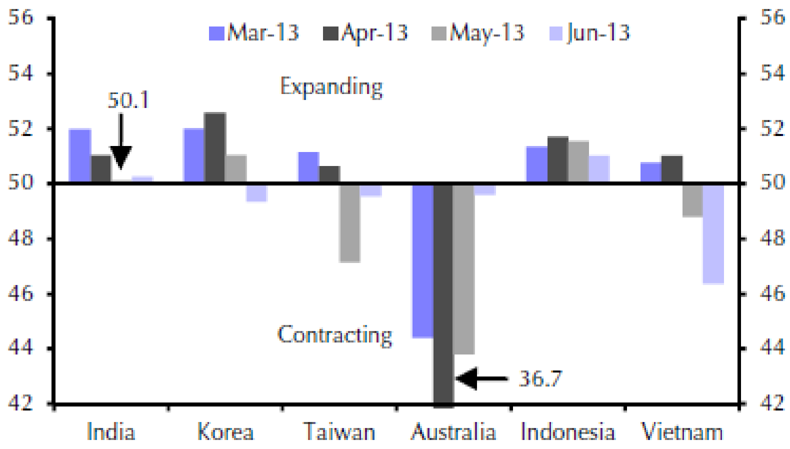
- China's cash squeeze is likely to reduce credit growth this year by 750B yuan ($122B). An amount equivalent to a full month of net new credit at national level. The majority of analysts close to that economy admit the short term effects that this may have in the economy but they also approve the government's handling of the credit crunch, considering that this episode reinforces their expectations for policy reforms such as loosening controls of interest rates.
- Additionally, the Ministry of Finance issued a circular ordering central government agencies to cut their general expenditures in 2013 by 5%. Analysts expect now 7.5% growth in Q2 (from 7,7% in Q1) as credit tightening and overcapacity continue to weigh on the economy.
- Admittedly, June PMIs for EM Asia point to a loss of economic momentum in manufacturing sector; and going beyond the headline figures, the main feature has been a deterioration in new orders, which points to a poor performance of the industrial activity in the short term.
- On the positive side, this slowdown in manufacturing activity ensures that central banks will be very cautious about tightening monetary policy. **Keeping policy rates low in Asia should act as an anchor on local-currency bond yields. As a result of the recent sell off in regional government bonds, yields are now significantly above policy rates, in what represents a good opportunity of entry.**
- On the fundamental side, commercial links of these economies with developed economies are not as large as in the past. The major part of emerging Asia economies have commercial links with the US that barely represents 4% of GDP. **This points to a certain degree of economic autonomy.**
- Despite the fact that some of the US growth will be led by a more competitive manufacturing sector in the US, **this will not represent a challenge for NIEs economies in Asia (newly industrialized economies) since they are still well-placed in terms of competitiveness.**
- Despite wage costs have risen at a fast pace in most Asian countries, **they still remain a fraction of US costs,** and despite these economies still have a lower productivity, **they are closing that productivity gap**, being China the economy showing the greatest progress.
- **Asian economies have actually gained in competitiveness compared with rivals in Latin America and Europe in the last decade,** meaning that if western economies (and the global activity) continue their gradual pace of recovery, Asian economies should not experience any significant decline in the pace of expansion.

Admittedly, June PMIs for EM Asia point to a loss of economic momentum in manufacturing sector, that continues to struggle

❑ The headline index only rose m/m only in three of the seven countries for which we've had references.

- ✓ Positive readings (3): Taiwan, India and Australia
- ✓ Negative readings (4): China, Vietnam, S.Korea and Indonesia (although in the latter, manufacturing activity keeps expanding)

Headline PMIs



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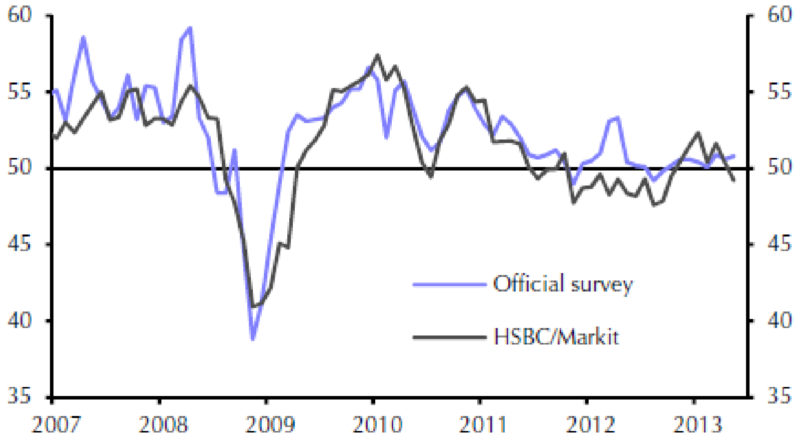
Headline PMI (China)



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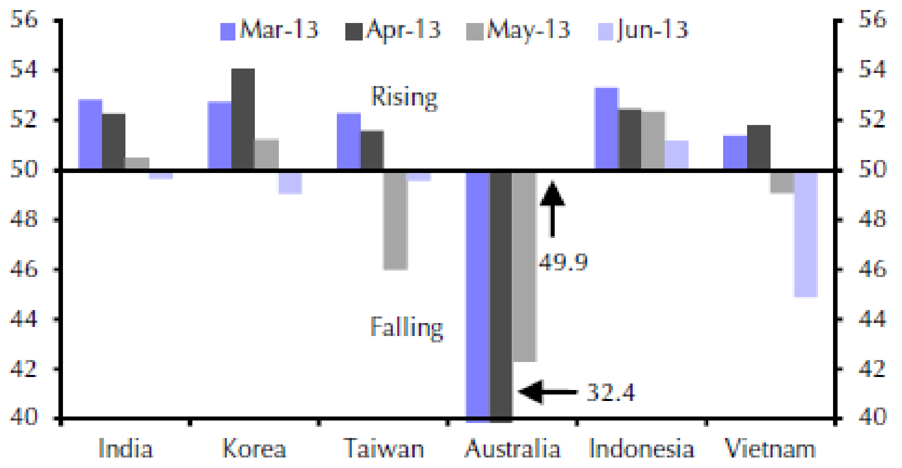
And going beyond the headline figures, the main feature has been a deterioration in new orders.

❑ Which points to a poor performance of the industrial activity in the short term.

- ✓ The significant bounce seen in Taiwan & Australia should be read in a context of prior weakness (since they follow exceptional weak readings)
- ✓ The new orders component was at or below the 50 level for all but Indonesia (where the headline also points north).
- ✓ Likewise export orders were weak across the board. This is particularly bad news for South Korea and Taiwan (both below 50)
- ✓ **In light of this development, we conclude that Indonesia remains the most attractive investment option at the moment; while Korea & Taiwan would be the worst option for us.**

New Orders



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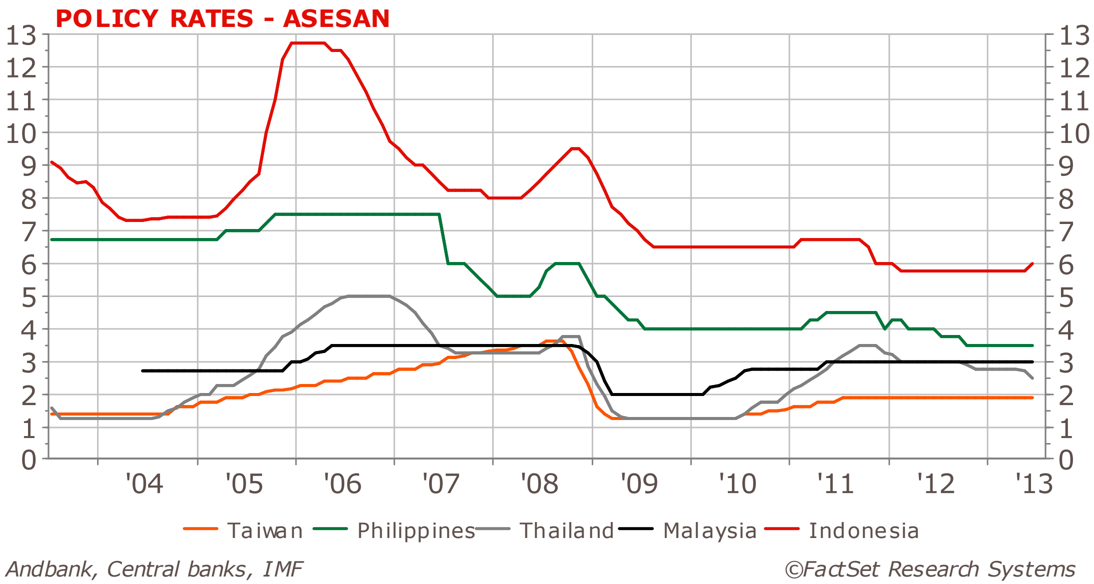
On the positive side, this slowdown in manufacturing activity ensures that central banks will be very cautious about tightening monetary policy. The implications are clear

- Keeping policy rates low in Asia should act as an anchor on local-currency bond yields

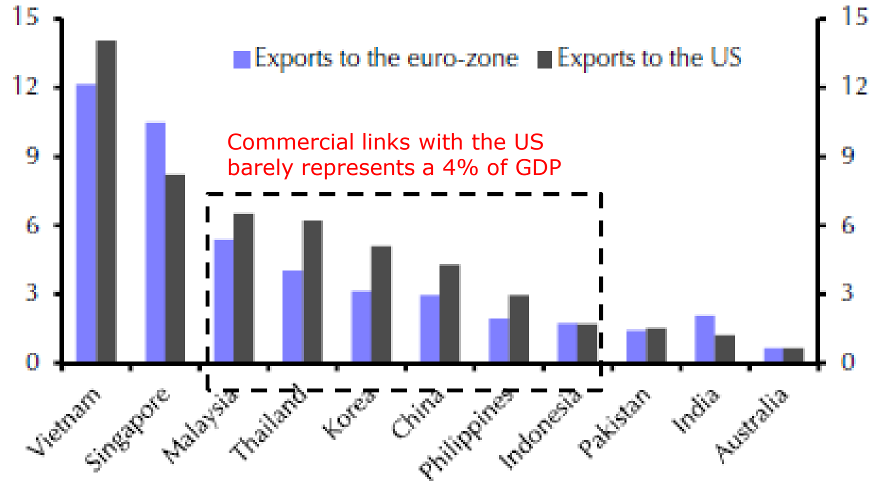
- Recent sell off in regional government bonds have brought yields significantly above policy rates, in what represents a good opportunity of entry.



Commercial links with developed economies are not as large as in the past. This points to a certain degree of economic autonomy.

- ❑ <u>These economies are not as dependent on the West</u> (developed) as one could imagine. Excluding unrepresentative cases like Vietnam or Singapore, the rest of emerging Asia economies have <u>commercial links with the US that barely represents 4% of GDP.</u>
- ❑ Commercial dependence is even lower when it comes to the euro-zone. Barely a 3% of their GDP.

Asian Exports (2012, % of GDP)



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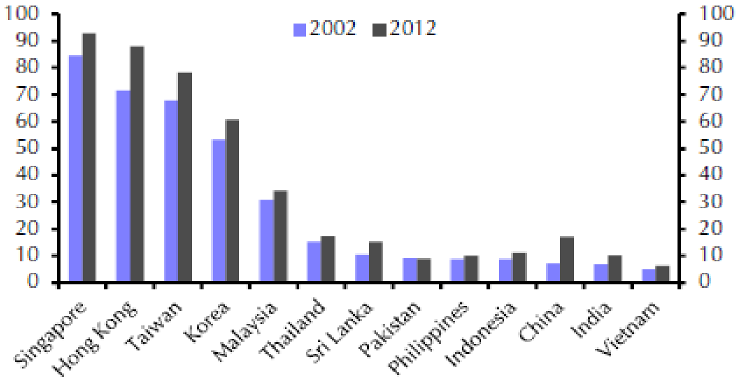
We still expect "decent" figures coming from the US, and... despite the fact that some of this growth will be led by **a more competitive manufacturing sector in the US, this will not represent a challenge for NIEs economies in Asia.**

Labor Productivity (as a % of US Level)



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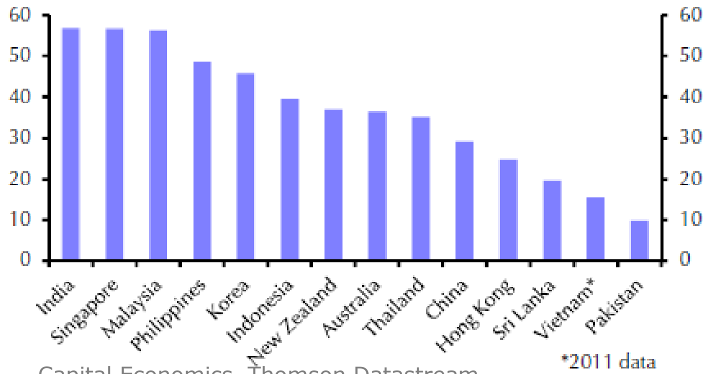
Exports of Intermediates to US



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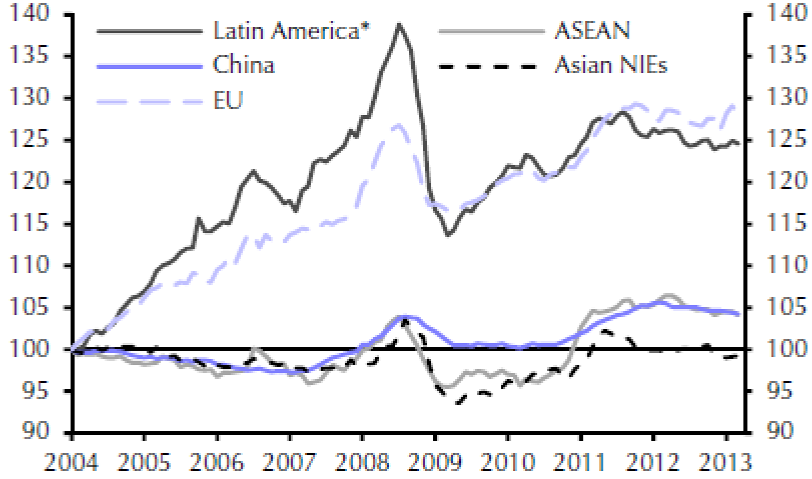
- A combination of falling energy costs, new technologies and affordability of US workers means that outlook for the US manufacturing is better now.
- The best performing manufacturing sectors in the US recently have been: Producers of machinery, electronics and motor vehicles.
- That puts Singapore, Taiwan and Korea in the cross-hairs because the first two are specialized in machinery and electronics. The latter in electronics & motor vehicles..
- The rest of Asian economies are well-placed in terms of competitiveness, because despite wage costs have risen at a fast pace in most Asian countries, they still remain a fraction of US costs.
- And despite these economies have lower productivity, they are closing that productivity gap, being China the economy showing the greatest progress. (see the upper chart)
- Additionally, a significant portion of the goods these economies send to the US are intermediate products rather than final goods (see the chart below). As such, most of Asian manufacturing economies will benefit from increased US demand for inputs.

Some analysts fear a sharp slowdown in economic growth in Asia but, according to our projection of "decent" data coming from the US (and European figures in 2013 better than in 2012), this hypothesis simply does not hold

- In order to have a broad picture of how competitiveness is evolving across the different regions around the world, we can compare the prices that the US is paying for its imports from various regions

- As the chart shows, Asian economies have actually gained in competitiveness compared with rivals in Latin America and Europe, **meaning that if western economies (and the global activity) continue their gradual pace of recovery, Asian economies should not experience any significant decline in the pace of expansion**. (Of course, unless it is a slowdown induced from regional politics. In such a case, the short-term pain should be offset with long-term benefits)

US import prices by region (index)



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