Atradius

Managing risk, enabling trade

The trade war doesn't spoil the party

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Introduction

For many years, the emerging economies in Asia have been the main growth engine of the world economy. Next to the big economies of China and India, the Southeast Asian countries have contributed strongly to global GDP growth. This year, several developments give reason to be worried about the growth outlook for the region. The escalating trade war between the US and China, monetary tightening by the Fed and - in connection with this - rising risk aversion towards emerging markets will leave their mark. Export growth is expected to slow the next two years, and for some countries it will be more difficult to finance their external deficits. Still, we are not very concerned. The impact of weaker global trade on overall GDP growth in Southeast Asia is just moderate, because domestic demand stays strong, there is room for countervailing macro policies and the trade war also has some positive consequences.

Regarding Fed tightening, we consider it unlikely that the bigger Southeast Asian countries will face a financial crisis because of higher interest rates in the US and less risk appetite at financial markets. Global investors are aware that in the last two decades sound macro policies have strengthened their economies. Larger buffers and flexible exchange rates are reason to expect that countries dependent on external financing can cope with diminishing appetite for their bonds and equities. The outlook for Southeast Asia has weakened, but still is quite rosy.

From global trade war to bilateral battle to China versus the rest

Recent developments show that the trade war is escalating between China and the US, but is more or less moderating on other fronts. The US has closed deals with Mexico, Canada and South Korea, whereas the skirmishes between the US and the EU have evolved into some kind of truce. The main target of the US trade policy, China, however, fell victim to consecutive measures by the Trump administration, and China has hit back strongly. Though a global trade war does not seem to be the case anymore, the trade conflict between the US and China may have serious consequences for both global trade and the world economy. Southeast Asian countries will feel the impact because China and the US are their main export destinations, and their economies are part of global supply chains which can be hit by a weaker global economy.

Important in this respect is how long the trade war between the two economic powers will last. The longer the trade war lasts, the bigger the impact will be. Prospects for de-escalation in the short term are low. The trade war has been instigated by a mercurial US president who firmly beliefs that bilateral trade deficits are wrong for his country. Important for the US' firmness for the longer term is that many US politicians see China's rise towards an economic super power as a threat for their country. The likelihood of de-escalation, however, may rise over time as the increasing economic impact in the US will make the Trump team less combative and China will experience more problems to combine the much-needed deleveraging of the economy with stimulating measures to avoid a hard landing.

Helpful for a change in China's hard stance may be that the EU and Japan share the US concerns about close ties between state and business in China, the imposed sharing of technology by foreign companies investing in China and the absence of a level playing field in the trade relations. Also, the way China operates in the Belt and Road countries, connecting direct investments with voluminous lending practices, meets with increasing resistance. Chances are rising that US, EU and Japan will combine their efforts to change or even combat the way China operates in the world economy. China will realise that it will be hard to keep good economic relations with other countries without some concessions regarding its specific economic model.

Moderate impact on economic growth

Though the trade war may de-escalate in the longer term, it is worthwhile to look at the consequences for Southeast Asia. The five biggest economies in the region are all experiencing the headwinds resulting from the US-China trade war. Lower export growth this and next year, however, is not resulting in a sharp growth deterioration in one of these countries. In fact, the export growth decline mostly is related to the growth slowdown of the Chinese economy, which was underway independently of the trade war.

Real GDP growth (YoY)					Exports growth (YoY)				
	2017	2018	2019	2020		2017	2018	2019	2020
Indonesia	5.1	5.1	5.1	5.3	Indonesia	9.1	5.5	5.3	6.1
Thailand	3.9	4.4	3.4	3.1	Thailand	5.5	5.0	3.3	3.7
Malaysia	5.9	4.9	4.6	4.1	Malaysia	9.4	2.8	3.8	3.6
Philippines	6.7	6.4	6.0	5.6	Philippines	19.5	8.1	6.4	6.3
Vietnam	6.8	6.7	6.3	6.2	Vietnam	20.3	18.2	9.6	6.2

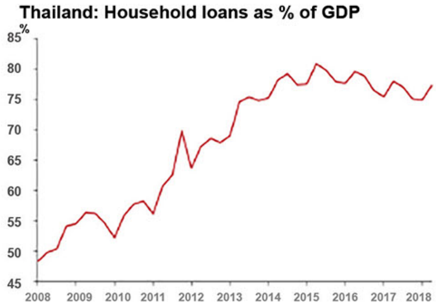
Source: Oxford Economics

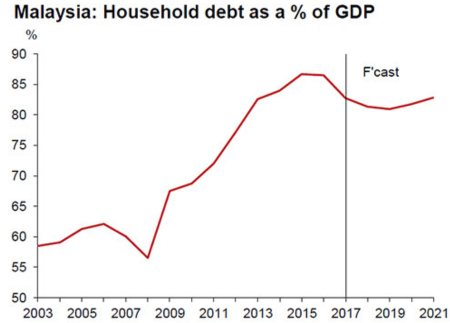
In Indonesia, the largest economy in the region, export growth is slowing substantially this year. Whereas China is Indonesia's most important destination for goods exports and commodities account for over half of goods exports, China's shift towards a more consumption-oriented economy has a negative impact on Indonesian exports. On the positive side, however, exports account for just 22% of GDP, which is markedly lower than for Thailand (78%) and Malaysia (73%). This means that in Indonesia strong domestic demand will offset the drag from net exports. Election-related spending will support private consumption this year and early 2019 and business investments remain growing strongly. Monetary policy tightening to cushion the economy from the impact of market turmoil is expected to have just a minor impact on domestic demand.

Rupiah under pressure, but sharp fall unlikely

More impact, not on growth but on currencies, has had increasing risk aversion on financial markets. Several emerging markets fell out of favour during the summer, which was reflected in capital outflows and depreciating currencies. The rout started in Argentina and Turkey, countries with policy mistakes and political uncertainty. At the peak of the unrest, both countries experienced severe currency crises, which dragged down the currencies of other countries dealing with policy uncertainty and/or external and fiscal weaknesses. The Indonesian rupiah and the Philippine peso came under pressure as well, though to a much smaller extent than many others. Unlike the other three main ASEAN countries, Indonesia and the Philippines both have a current account deficit, with together with deficits on the government budget, brings both countries in the category of economies with 'twin deficits', something the currency markets often respond to negatively in turbulent times. A difference between Indonesia and the Philippines is the relatively large reliance of the former on volatile portfolio investments in the financing of the external deficit, and which also may be the explanation of the partial recovery of the peso against the US dollar in October, which stayed away for the rupiah. Foreign investors hold about 40% of Indonesian government bonds, which makes the currency vulnerable for further monetary tightening by the Fed and decreasing risk appetite at financial markets. Further depreciation of the rupiah against the US dollar and the euro is likely in the coming year. A sharp fall of the currency, however, is unlikely, since the economy is doing well and the Indonesian central bank will support the exchange rate by raising the official interest rates.

Thailand's economy is weathering the trade war reasonably well. Export growth will slow in the coming two years, but no dramatic shifts are expected as a result of the US-China trade war. Chinese import demand is cooling, but strong services exports in the form of tourism mitigate the impact on export growth. Real GDP will be supported by public infrastructure investments and private consumption, both stimulated by the government to shore up its falling popularity. More worrying are some domestic weaknesses. First, political tensions may re-emerge. Since the coup four years ago, Thailand has been under military government with little progress towards a return to genuine democracy. Divisions between the two main political groupings will persist, making the danger of serious political instability an ongoing risk for international trade and investments. A second problem is the high level of household debt. Although bank lending growth has slowed since 2013, households are very indebted. Low inflation and a large external surplus supporting the baht mean there is plenty of scope for continued accommodative monetary policy. The negative side of that, however, is that this would encourage firms and households to become even more indebted. When interest rates finally start to rise, this could result in greater financial stress.





Source: Oxford Economics

Malaysia's highly open economy is more susceptible to weaker external demand and, more specifically, weaker demand from China. Malaysia is one of the most vulnerable countries to the tariffs the US has imposed on Chinese exports. After rapid export growth in the first half of the year, high base effects will dampen growth in the second half. A normalisation in natural gas production will support exports to a certain extent, but due to the expected slowdown in world trade, export growth this and next year will be lower than in 2017. But also here, the domestic economy keeps GDP growth at a reasonable rate. Household spending remains buoyant this year given the boost to disposable income from fuel subsidies and the replacement of the goods and sales tax with a lower sales services tax. The impact of these measures however will decrease in the course of next year and rising domestic borrowing rates will lower household purchasing power. The postponement or suspension of long-term infrastructure projects will slow growth in gross fixed investment. The Malaysian ringgit did relatively well this year, due to the current account surplus and the central bank's rule that 75% of export proceeds must be converted to the ringgit. The currency, however, still is vulnerable for worsening market sentiment because, like for Indonesia, a relatively large proportion of government debt is owned by foreigners (despite this proportion is falling in the last two years).

Economic growth in the Philippines will slow gradually in the next two years, but this can be attributed only partially to exports losing momentum. After last year's strong performance, exports volume will increase a still healthy 8%. Imports of goods and services growth will stay high, resulting in this year for negative contribution of net exports to GDP growth for the fourth consecutive year. Like in neighbouring countries, domestic demand keeps up the GDP growth rate. Government expenditures will rise with more than 10% because of an extensive infrastructure programme and private consumption stays strong because remittances still support household incomes. Next to net exports, the main reason that GDP growth is slowing is that fixed investment cools from the double-digit rates of growth posted over the past five years, due to tighter monetary policy and nervousness at investors about president Duterte's controversial way of governing his country.

Amongst the five bigger economies in Southeast Asia, Vietnam will keep the highest growth rate in this year and next, and relatively strong export growth will contribute to that. The US-China trade skirmishes will have a negative impact on exports to China, which is the number three export destination, after the US and the EU. But, different from the other countries, Vietnam will benefit by gaining a larger market share at the expense of China, especially in the readymade garments (RMG) sector. Vietnam is the world's third-largest exporter of RMGs and exports about 50% of it to the US. But also in other sectors Vietnam is in a relatively good position, since almost 20% of GDP is reliant on the US as export destination, whereas this is 6 to 7% for Malaysia and Thailand and just 2 to 3% for the Philippines and Indonesia. If Chinese companies decide to move production to other countries (like they did when the EU and US imposed penalties on Chinese solar panels in 2012) Vietnam is in the best position to accommodate such a shift. Domestic demand, in the meantime, will show healthy growth because of growing tourism and strong labour market conditions.

Increased strength, but still some vulnerabilities

Important for our assessment that Southeast Asia is weathering the trade war and increasing risk aversion on financial markets quite well, is that the fundamentals of the various economies are strong enough. Before the Asia crisis of 1997/1998 most countries had current account deficits, US dollar pegs and much tighter foreign exchange reserves. That has changed. The table below, however, shows that the situation differs from country to country and that most of them still have one or more vulnerabilities.

	foreign debt	foreign debt	debt service ratio	current account	ext. financing requirement	import cover	fiscal balance	inflation (CPI)	household debt
	% GDP	% exports	% exports	% GDP	% reserves	months	% GDP	%	% GDP
warning level	*40.0*	*200.0*	*25.0*	*-3.0*	*100.0*	*3.0*	*4.0*	-	-
Indonesia	35.4	158.3	27.6	-2.9	111.8	6.4	-2.6	3.9	16.7
Thailand	29.0	39.8	5.3	9.3	13.3	9.0	-2.9	1.2	67.2
Malaysia	62.3	83.6	5.5	2.6	87.8	5.6	-3.3	0.9	67.4
Philippines	23.7	56.7	8.7	-1.4	33.0	7.3	-2.8	5.1	15.5
Vietnam	45.4	39.8	4.0	1.8	35.4	2.8	-6.3	3.7	n.a.

Source: Macrobond, Atradius; data for 2018

As mentioned above, Indonesia's dependency on external financing and the high share of Indonesian government debt in foreign hands makes the economy vulnerable in periods of declining risk appetite on global financial markets. Thailand and Malaysia both have high levels of household debt, which can bring down economic growth if interest rates rise sharply. Vietnam has a weak liquidity situation and a high budget deficit (and high public debt as well). But in none of the five countries the situation is alarming. In Indonesia, president Joko Widodo's government has been successful in improving economic stability by reducing the burden of regulations and launching reforms to increase productivity and the inflow of foreign direct investments. Keeping the current account deficit below 3% GDP is a major policy priority. Thailand has sustainable external debt levels, a current account surplus and adequate reserves. The main weakness of the country, high household debt, seems to have peaked three years ago. Also in Malaysia household debt has peaked and persisting high government deficits developed in the right direction. Still, Thailand and Malaysia are the most vulnerable to higher borrowing costs, which may be reinforced by the risk of increasing US trade protectionism, as they have strong trade linkages with the US. In the Philippines, the now small current account may increase, but the country's strong trend growth and ample foreign reserves should limit the danger of extreme financial market volatility. Vietnam shows the most weak spots in the table below, but the vulnerabilities are decreasing. Its foreign debt as a percentage of GDP is high, but relative to export revenues it is low. Government debt has been fairly stable and well financed, with long maturities and financed by public creditors. Debt service ratio is low. International reserves are gradually rising, and the import cover will reach three months this year.

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