Economic Research Institute for ASEAN and East Asia

Policy Brief

China's Ties with Southeast Asia : From Green Shoots to Sustained Recovery

By Kensuke Tanaka

1. China's rapid rebound and challenges ahead
2. China leading the recovery of Southeast Asia : Some recent evidences
3. The way forward : Regional macroeconomic co-operation for sustained recovery

China's rebound happened relatively quickly owing to a large extent to timely macroeconomic policy responses to the crisis. Lagging somewhat behind China, most Southeast Asian countries have now entered the transition from recession to recovery. Some export-dependent Southeast Asian countries shifted their export destination to China to benefit from its early recovery. This switch of export destination to China illustrates China's important role in leading the recovery of the region. Enhancing regional macroeconomic co-operation would help reduce vulnerability of the region and ensure a sustained recovery. Regional macroeconomic co-operation remains at an early stage in Southeast Asia, but possibilities for further co-operation should be explored.

1. China's rapid rebound and challenges ahead

China's rebound happened relatively quickly owing to a large extent to timely macroeconomic policy responses to the crisis. According to the newly developed OECD Asian Business Cycle Indicators (OECD ABCIs, see Box1), China's composite leading indicator (which has a 5-6 month lead time) has already bottomed out and the economic outlook has improved substantially in recent months (Figure 1): China recorded the trough of the business cycle in November 2008, right after the Lehman collapse, and afterwards a constantly increasing trend can be observed. More recently, the composite leading indicator returned to an expansionary phase (which is defined as exceeding 100 points in Figure 1) in June 2009; given the 5-6 month lead time of the indicator, this means that the Chinese economy had already moved into an expansionary phase around December 2009. In addition to that, the historical diffusion index also supports this pattern of recovery in China.

In recent months, China's growth has been supported by strong fixed asset investment and on the supply side, production in the manufacturing sector appears to have entered a recovery path. Trade data also confirm these signs of recovery, although trade figures had been showing sluggish trends until recently in China. Judging from these signs, the extraordinary macroeconomic policies appear to have succeeded in preventing the Chinese economy from deteriorating too long and too much. The relatively healthy state of the Chinese financial sector on the eve of the crisis also spared resources from being spent on pricey bailout schemes. The recovery is expected to further gain momentum in the coming months and into the second half of 2010, although its robustness is hinging upon the management of exit strategies.

In comparison, recovery in OECD countries has been lagging behind China's by approximately half a year (Figure 2). Looking at the longer term, the apparent decoupling between OECD countries and China which was observed at early stages of recovery is expected to fade away.

Figure 1. Business cycles of China

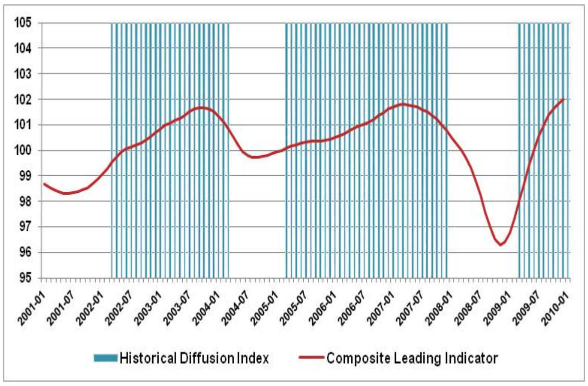
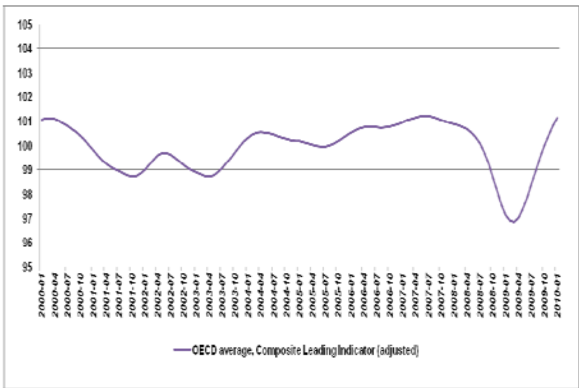


Figure 2. Business cycles of OECD average (adjusted)



Note: Data are as of March 2010.

Source: OECD Asian Business Cycle Indicators (OECD ABCIs) and OECD Composite Leading Indicators (OECD CLIs).

A key for the rapid recovery in China is that the economy was able to enjoy relatively large policy space in conducting both monetary and fiscal policies, since China was in a good shape when the global crisis hit:

- Owing to healthy economic situation, China not only cut interest rates and lowered reserve requirements in the second half of 2008 but also expanded the flow of credit to the private sector by lifting the ceilings on credit growth in the first quarter of 2009. In addition, as for the exchange rate in the second half of 2008, China abruptly halted the policy of allowing the renminbi to appreciate gradually against US dollar to support the stability of the market.
- On the fiscal front, China had a particularly large fiscal package, mainly concentrated in public investment. The sizable package comprising measures for a two-year stimulus worth 4 trilion renminbi (approximately 16% of GDP, i.e. 586 billion USD) was announced in November 2008 immediately after the start of the crisis. The swift adoption of the package is thought to have been effective to prevent an excessive drop in growth. The sufficient fiscal policy space China enjoyed was crucial in affording such a large package, and the need for infrastructure provided a rationale for a quick expansion of public investment in key infrastructures.

Coupled with the impact of monetary easing, China's fiscal expansion appears to have played a key role in supporting the country's economic recovery. There are, however, several risks to China's future economic outlook.

- Well- tailored exit strategies are crucial. Early rebound in China has raised the challenge of how the country should go with exit strategies. There exists a simple trade-off here: as in case of reducing the stimulus soon, the recovery could falter and fall into a double-dip. But exiting too late may lead to a further build-up in asset price bubbles and a higher inflation.

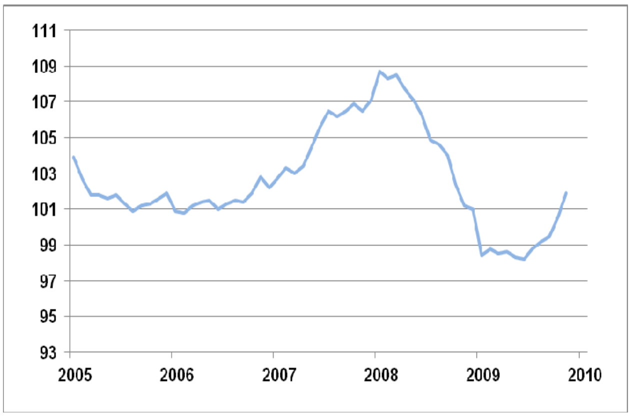
In general, exit policies should first start with monetary policies with exiting from fiscal stimuli following later. So far tightening measures on the monetary front comprise raising the reserve requirement ratio in January 2010 and a window guidance to rein in liquidity. More caution, however, should be taken about an interest rate hike since it could generate hot money inflows.

For the time being the monetary stance should remain relatively accommodating, and China will likely prevent its currency from appreciating too fast given the consequence of losing competitive positions. The withdrawal of fiscal stimulus should also be carefully planned. Overall, the current fiscal condition is healthy in China but the long-term impact should be examined carefully.

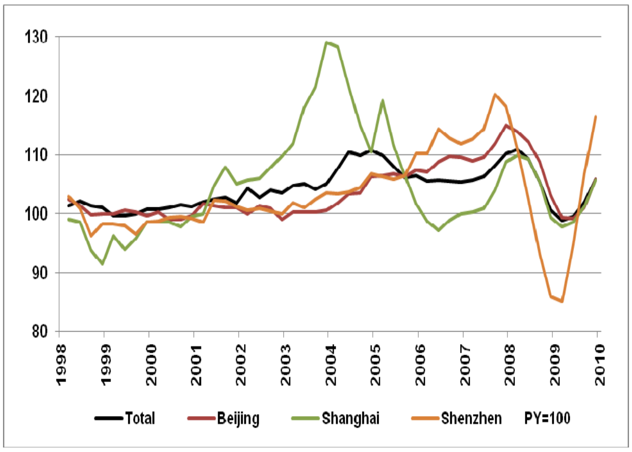
- Inflationary pressure has been gradually building. Consumer price index in China started to increase in late 2009, as the economy got into an expansionary phase. (Figure 3, a). At the same time, the real estate market recovered rapidly in China (Figure 3, b). The similar trend can also be observed in the stock markets in China and several ASEAN countries (Figure 3, c). It is therefore important to ensure that exit strategies should be also consistent with the climate in these markets.

Figure 3. Inflationary pressures building up in China

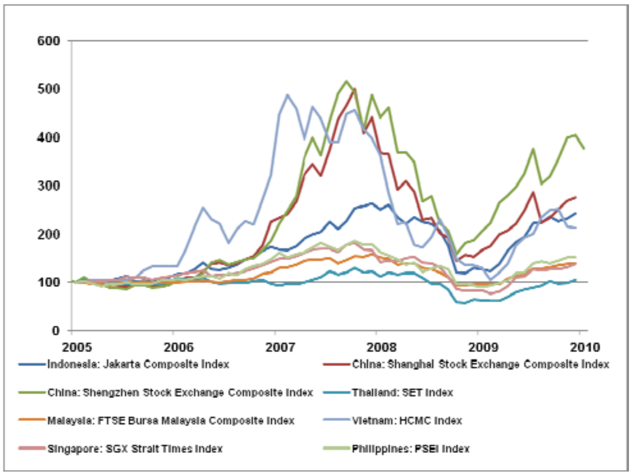
a) Consumer price index (Base year 2005 = 100)



b) Property prices in China (Base year 2005 = 100)



c) Stock price index of China and selected ASEAN countries (Base year 2005 = 100)



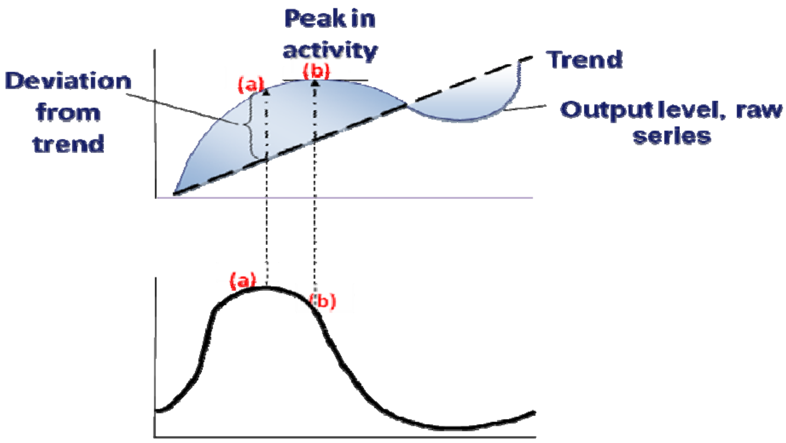
Source: CEIC.

Box 1. OECD Asian business cycle indicators and OECD composite leading indicators

The OECD Asian Business Cycle Indicators (OECD ABCIs) have been constructed jointly by the OECD Development Centre and the OECD Statistics Directorate for selected Asian countries starting in 2009. The purpose of these indicators is to provide i) comparable information on the short-term economic situation in different countries to encourage policy dialogue in the region, ii) early warning of potential macroeconomic risks in the region and iii) serve as a tool to trace business cycle synchronisation in Asia. These indicators will be used for the Southeast Asian Economic Outlook to be issued by the Development Centre in November 2010.

The OECD ABCIs are based on the "growth cycle" approach like the OECD Composite Leading Indicators (OECD CLIs), in which cycles are measured as deviations of economic activity from their long-term trend (See point (a) in Figure4). OECD ABCIs use the same de-trending method as the OECD CLIs.

Figure 4. Growth cycle approach



Source: Author's compilation.

Different from the OECD CLIs, the OECD ABCIs identify the cycles by using both a composite index and a diffusion index. Each provides different types of information and as such they are complementary: While the composite index reveals "changes" in economic fluctuations, the diffusion index gives a broader picture of the overall economic situation and its movement. The Historical Diffusion Index of OECD ABCIs, which is built from the same component series as the Coincident Component Indicator reflects the overall economic activity of the country.

Composite Leading indicators of OECD ABCIs recognise four cyclical phases 1) expansion, 2) downturn, 3) slowdown and 4) recovery*. In contrast, the historical diffusion index of OECD ABCIs has only 2 phases: expansion and slowdown. The historical DI is defined by the share of series with plus signs. In principle, the turning points will be detected by whether the historical DI is above or below 50%. The trough of the cycle will be the month before the diffusion index crosses the 50% threshold from below and the peak will be the month before it passes from above. The turn of the business cycle by the historical diffusion index will be judged by overall economic activities.

In this way, OECD ABCIs grasp business cycles by using comprehensive source of information.

(Note) (*) 1) expansion- the curve is increasing and it is above 100, 2) downturn- the curve is decreasing and it is above 100, 3) slowdown - the curve is decreasing and it is below 100, 4) recovery - the curve is increasing and it is below 100.

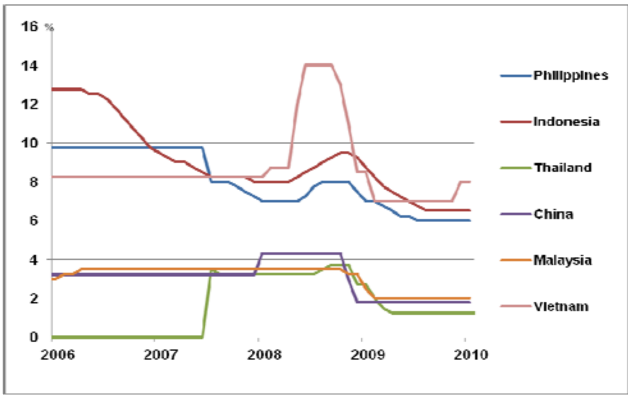
2. China leading the recovery of Southeast Asia: Some recent evidences

The global financial crisis has severely impacted on Asia since late 2008. Southeast Asia's regional economic outlook started to improve just a few months ago and most Southeast Asian countries have now entered the transition from recession to recovery. The pace of recovery differs across countries, however. In general, export-oriented economies such as Malaysia and Thailand were hit by the crisis much harder than less open ones.

The difference in the recovery pattern between China and export-dependent ASEAN countries is not only related to the dependence on exports but also to the limited policy space. Indeed, monetary and fiscal space varied across countries: The countries whose pressing concerns were the inflationary consequence of overheating and rising commodity prices had relatively large space such as Indonesia and in contrast, other countries already pursuing easy monetary policies with low interest rates had little monetary policy space such as Thailand and Malaysia when the crisis hit (Figure 5).

The OECD ABCIs for Malaysia and Thailand (Figure 6 and 7) suggest that business cycles have moved away from recent lows and now exhibit rebounding trends: In Malaysia, the trough was recorded in December 2008 and the indicator passed the threshold of 100 points in October 2009. For Thailand, it bottomed in October 2008 and exceeded the 100 points in August 2009. Both countries have similar recovery paths although the engine of the growth differs: In Malaysia, electronics and the IT industry show the sign of recovery and growth is led by recovery of

Figure 5. Policy rates of selected Southeast Asian countries and China, 2006-2010



Source: CEIC.

Figure 6. Business cycles of Malaysia, 2001-2010

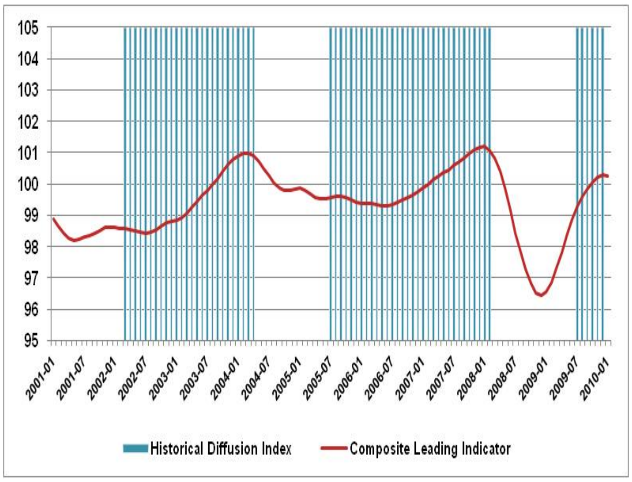
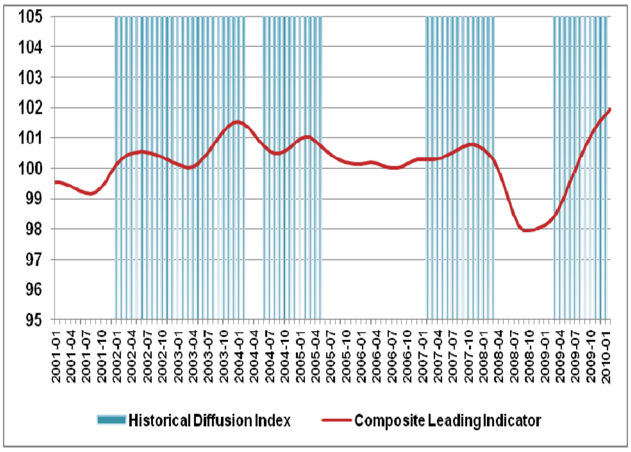


Figure 7. Business cycles of Thailand, 2001-2010



Note: Data are as of March 2010.

Source: OECD Asian Business Cycles Indicators.

the private sector rather than by the stimulus. In Thailand, following the recovery of exports, overall economic activity is on the good track but these economic sentiments may be discouraged by political uncertainty.

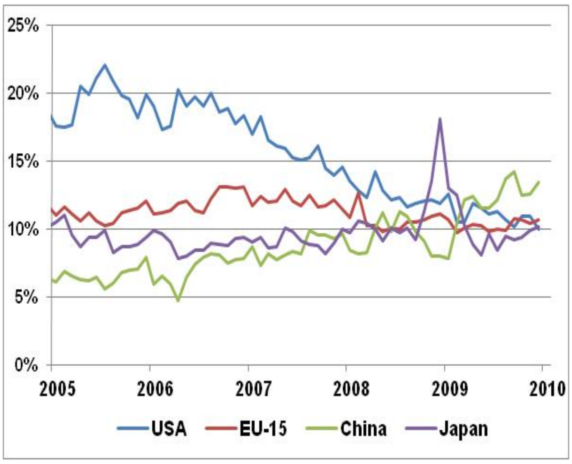
Observing recent business cycle trends using the OECD ABCIs, two interesting issues can be highlighted, namely, i) Southeast Asian countries' strategies for recovery from the view point of business cycles and trading partners in the region, ii) the role of demand led by China from the view point of rebalancing growth.

- Some export dependent-Southeast Asian countries shifted their export destination to China to benefit from the early recovery of China. This switch of export destination to China, clearly observed in Malaysia and Thailand, illustrates China's important role in leading the recovery of the region. In this way, enhanced regional integration acted as a buffer in the global recession. (Figure 8, a and b). It could be the case that production fragmentation and elaboration of global supply chains for the manufactured products in which emerging Asia specializes in particular, have somehow increased the sensitivity of trade with respect to the cycle (See Research Brief by Yamano, Bo and Fukasaku). This evidence suggests that China is likely to be even more integrated with the Southeast Asian region as a result of the present crisis.

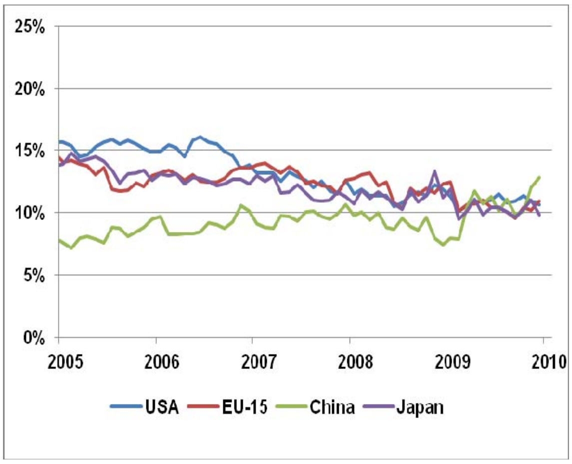
  A Free Trade Agreement (FTA) between China and ASEAN that has come into effect this year will help to enhance relations between Southeast Asia and China. As of January 2010, tariffs have been abolished on more than 7,000 items or 90 % of the total number of tariff lines for China and 6 ASEAN members -Indonesia, the Philippines, Thailand, Singapore, Malaysia and Brunei. The four remaining ASEAN countries - Vietnam, Laos, Cambodia and Myanmar – will maintain tariffs until 2015.

Figure 8. Share of major trading partners (exports shares relative to total exports)

(a) Malaysia



(b) Thailand



Source: CEIC.

- Regional demand led by China is important in the context of enhancing regional integration. The necessity of rebalancing growth in China was usually addressed in the context of global imbalances but it should be also important in the context of regional integration. One of the lessons from the crisis is that the strategy of export-led growth implies excessive exposure to external shocks. As the sharper decline in activity in more open economies shows, excessive dependence on trade can have a detrimental impact on export industries. Unbalanced growth emphasizing exports creates vulnerabilities just like excessive dependence on foreign finance. Evidently trade as well as finance can exhibit sudden stops.

3. The way forward: Regional macroeconomic co-operation for sustained recovery

Enhancing regional macroeconomic co-operation would help reduce vulnerability of the region and ensure a sustained recovery. Regional co-operation in macroeconomic policies, however, lags behind other forms of co-operation and needs to be strengthened to enhance stability in the region. The current crisis has brought this debate to the forefront.

There is already a well-functioning example of macroeconomic co-operation. In the area of liquidity provision, the scheme of swap arrangement was established in the framework of ASEAN +3, the so-called Chiang Mai Initiative, which has recently evolved from a series of bilateral agreements to a multilateral one.

Beside liquidity provision, co-operation in many other areas is expected to be strengthened especially as economies move from the green shoot stage to sustained recovery:

- There is also an increasing debate on "coordinated exit strategies" in the context of G20 and in Asia as well. The collapse of Lehman Brothers in September 2008 exacerbated a credit crunch and froze money markets, sending inter-bank rates soaring and shaking confidence of the financial system. Especially in the context of financial prudential regulation, there is an example for co-ordinated exit strategy. Singapore, Malaysia and Hong Kong, China agreed in November 2009 to jointly exit from full guarantees offered on bank deposits. This plan to invoke and revoke government guarantees can have a significant impact on the flow of capital especially in a risk-sensitive environment.
- The countries that exit earlier than OECD countries have to manage the capital inflows and their impact on exchange rates: i) Concerning exchange rate issues, Asian economies entered the onset of the crisis with considerable diversity in exchange rate regimes: Some countries such as Indonesia were floating with considerable flexibility, while others remained tightly managed. With the crisis, the Indonesian rupiah depreciated sharply while China terminated the policy of allowing the currency to appreciate gradually against US dollar. In the long run, the discussion of currency volatility will lead to the discussion of common currency but for the time being, collective currency pegs or common currency baskets would be an option in response to the volatility. ii) Concerning the issue of capital inflows, notably in China it will be an urgent issue to manage. Evidence on the effectiveness of controls on capital inflows is mixed - to the extent that capital controls are effective only for relatively short periods of time, such measures might be used at the time of surges of inflows rather than as permanent measures.

- Recent example from fiscal stimulus policies: fiscal stimulus will have international and regional spillovers both through trade and interest rate channels. Smaller countries perceive only part of the global benefit provided by their action; larger countries perceive only part of the costs involved. As the relative sizes of stimulus packages illustrate, more open economies have been less generous in terms of stimulating their economies being wary of such stimuli leaking to trade partners rather than benefiting domestic producers. This suggests room for regional co-ordination, while taking into account each country's scope for fiscal action.

Regional macroeconomic co-operation remains at an early stage in Southeast Asia, but possibilities for further co-operation should be explored. Sharing information on relevant economic indicators and available policy options in a timely and systematic manner should be given priority in this respect.[1]

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[1] The newly developed OECD Asian Business Cycle Indicators can be used to facilitate regional macroeconomic co-operation.

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ANNEX: List of Component Series for OECD Asian Business Cycle Indicators: Composite Leading Indicators

China

i) Construction orders
ii) Manufacturing - confidence indicator
iii) Industrial production: steel
iv) Monetary aggregate, M2
v) Production of motor vehicles
vi) Product inventory: metal products

Thailand

i) Minimum loan rate,
ii) Inventory to shipment index
iii) SET index
iv) Motor vehicle sales: commercial vehicle
v) Business expectation index
vi) Domestic cement sales

Malaysia

i) Production of rubber
ii) Production of electrical valves, tubes and other electronic components
iii) Consumer price index
iv) Housing approvals for construction (Private developers)
v) Money supply (M1)
vi) Equity market index

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