EAST ASIA UPDATES

ERIA
Economic Research Institute for ASEAN and East Asia
www.eria.org

Quarterly Edition (Q4) - December 2018

Navigated through Headwinds, Readying for the Next Challenge

2018 was a challenging year for policymakers in the East Asia region. Nonetheless, countries in the region were generally able to navigate through the challenges. As sources of downside risks remain, policymakers in the region need to remain vigilant and continue to push for reform. Global economic expansion in 2018, including the East Asia region, was lower than in 2017. This was in contrast with the projection and optimism at the start of 2018 and mostly due to various economic shocks followed by financial market volatilities. On economic performance in the second half of 2018, amongst advanced economies, the divergence in growth between the United States (US) and the eurozone continued in the third and fourth quarter, where the US continued to grow at a faster rate. Meanwhile, in the East Asia region, third quarter economic growth slowed compared to the second quarter in most countries. This was mostly driven by the contribution of negative net exports to growth, either due to a contraction in exports growth or a large pickup in imports growth. For the fourth quarter, the manufacturing purchasing manager index (PMI) shows expansion was unbalanced across the countries in the region. Around half of the countries recorded an expansion in manufacturing activity, while the other half recorded a contraction. On the financial front, market volatility increased from October, erasing the year-to-date returns of the global stock market. Similarly, most stock markets in the region recorded negative returns, and government bond yields in several countries increased. Consequently, almost all currencies in the region depreciated against the US dollar. Nonetheless, despite the volatility, policymakers in the region were largely able to maintain macroeconomic stability. Entering 2019, the global economic projection has been revised down due to various uncertainties. The main risks include unresolved trade tensions between the US and China, pressure on some emerging markets' macroeconomic stability, idiosyncratic country shocks, and the long-term challenges of increasing productivity and innovative capability, which rest upon investment in human capital.

Q4 2018 Economic Performance

The divergence between the US and eurozone economic performance since Q2 2018 continued in the second half of 2018. In Q3 2018, the annual gross domestic product (GDP) growth rate in the US increased from the previous quarter, while it decreased in the eurozone. In the US, as **Figure 1** shows, Q3 GDP growth was 3.0% year-on-year (yoy), slightly higher than its Q2 growth of 2.9%. This brought the year-to-date (ytd) growth in the US to 2.8%, higher than its 2017 growth of 2.2%. The US's Q3 growth rate was the highest in 3 years, supported by a broad-based pickup in household and government consumption as well as private investment. This was the result of a relatively good labour market and lower taxes. In the eurozone, Q3 growth was markedly lower, at 1.7% (yoy) compared to 2.2% (yoy) in Q2. This brought the ytd growth rate to 2.1%, also lower than its growth in 2017 of 2.4%. The decline in Q3 growth was mainly caused by lower global trade growth, lower household spending, and declining business confidence in some countries. In the United Kingdom (UK), Q3 GDP growth at 1.5% (yoy) was slightly better than its Q2 growth of 1.2%. This brought the ytd growth to 1.3%, still lower than the 2017 growth rate of 1.7%. The pickup in Q3 growth was supported by higher household spending and public investment. Private investment, however, continued to contract for the third consecutive quarter due to continued uncertainty about Brexit. For the fourth quarter of 2018, expansion in advanced economies is still expected, however, again with a diverging trend between the US and the eurozone. **Figure 2** shows that both manufacturing and service sector PMI in the US for Q4 displayed relatively strong expansion driven by overall expansion in the economy. For the eurozone and the UK, PMI expansion in Q4 was smaller than Q3, reflecting continued soft growth. Q4 manufacturing PMI in the eurozone saw its slowest expansion since mid-2016. This was due to declining exports, weak job creation, and low business confidence. The decline was similar in the UK, caused by lower new export orders and falling business confidence.

In the Southeast Asia region, Q3 GDP growth was slower than Q2 for most countries, driven by the general negative contribution of net exports to growth. As **Figure 3** shows, substantial Q3 GDP growth slowdowns were recorded in Singapore and Thailand, while mild slowdowns were recorded in Indonesia, Malaysia, and the Philippines. In Singapore, GDP growth in Q3 slowed to 2.2% (yoy) from 4.1% (yoy) in Q2. This was driven by slowing exports growth combined with higher imports, resulting in a negative contribution of net exports to growth. Household consumption also slowed slightly. In Thailand, Q3 GDP growth slowed to 3.3% (yoy) from 4.6% in Q2. This was driven by negative exports growth combined with faster imports growth, resulting in a large negative contribution of net exports to growth. Exports growth contracted for the first time in 3 years. Investment increased, partly due to continued accommodative monetary policy. In Indonesia, Malaysia, and the Philippines, Q3 GDP growth slightly slowed by 0.1 percentage points. In Indonesia, the slight slowdown from 5.3% to 5.2% was driven by slower household consumption growth, offsetting a pickup in government consumption growth. Government consumption growth increased to its fastest pace in 3 years, to 6.3%, partially due to spending on the Asian Games in August and September. In Malaysia, the slight slowdown from 4.5% to 4.4% was driven by negative investment growth and a negative contribution of net exports to growth. Investment contracted in the last 3 quarters in Malaysia, while the exports growth rate turned negative in Q3, the first contraction since mid-2015. In the Philippines, the slight slowdown from 6.2% to 6.1% was caused by slower household consumption and private investment growth. Government consumption and overall investment growth remained relatively high at 14% and 17%, respectively, contributing to higher imports growth. Viet Nam was the only country that recorded accelerating growth in the group. Its Q3 GDP growth increased from 6.7% to 6.9% in Q3. This acceleration was driven by higher exports growth and was the result of an upturn in foreign direct investment.

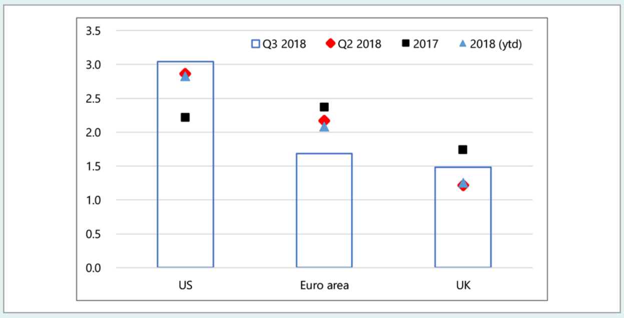
Similarly, in the Northeast Asian region, Q3 GDP growth also slowed compared to Q2, mostly driven by a fall in exports growth. In China, GDP growth slowed from 6.7% in Q2 to 6.5%, the slowest growth since 2009. This was partly due to slowing infrastructure investment and the government's efforts to reduce leverage amongst corporates, households, and local governments. The government, however, started to selectively deleverage and implement slight expansionary monetary policy to prevent a sharp reduction in growth. In Japan, GDP growth slowed considerably from 1.4% to only 0.3% in Q3, the slowest growth in 4 years. The slowdown was caused by a fall in exports growth, slower private consumption, and a contraction in government consumption. In the Republic of Korea (henceforth, Korea), GDP growth also noticeably slowed from 2.8% in Q2 to 2.0% in Q3, the slowest growth in 5 years. This was driven by a large contraction in investment growth of around –6%, the largest investment contraction in 5 years. Private and government consumption also slightly slowed, partly due to falling consumer confidence. Similarly, in India, despite continued strong growth, the GDP growth rate also slowed, to 7.1% from 8.2% in Q2. This was driven by faster imports growth (at 26% yoy) to support higher investment growth, resulting in a negative contribution of net exports.

For Q4, the manufacturing PMI indicates that economic expansion has been unbalanced across countries in the region. **Figure 4** shows that the Q4 PMI was relatively strong and higher than the Q3 average in Viet Nam, the Philippines, and India, the three fast-growing economies in the region. This strong expansion was supported by strong new export orders and higher business confidence. In other countries, the Q4 PMI shows a modest manufacturing sector expansion or even contraction. Contractions were recorded in Malaysia, Thailand, and Korea. In Malaysia, this was driven by a fall in output and new export orders as well as reduced business confidence. In

Panel 1. Recent Economic Developments

During Q3 2018, the annual GDP growth rate in the US and UK expanded more strongly than the previous quarter and it fell in the eurozone. The ytd growth rate was higher than 2017 for the US, but lower for the eurozone and the UK.

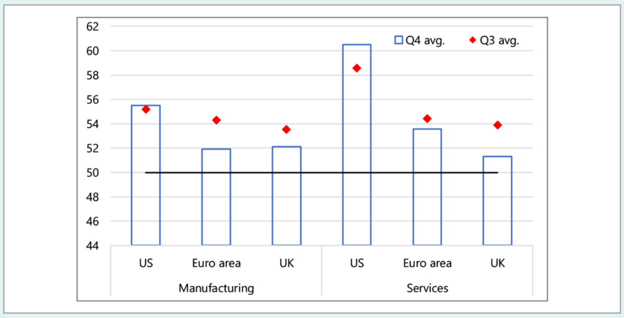
Figure 1. Annual Real GDP Growth Rate in Advanced Economies (%, seasonally adjusted)



Avg. = average, UK = United Kingdom, US = United States, ytd=year-to-date.
Source: OECD Statistics.

In Q4, the manufacturing and services PMI was still increasing in advanced economies. The expansion rate remained stable in the US, but decelerated in the eurozone and the UK compared to Q3.

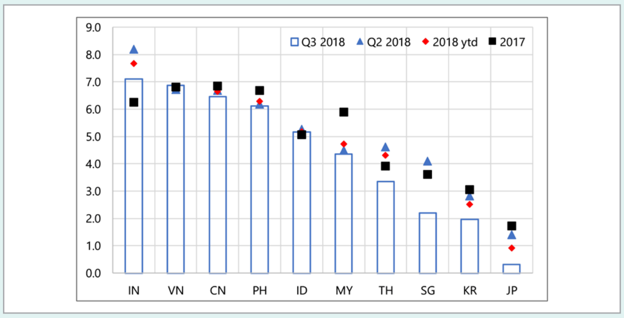
Figure 2. Global Manufacturing and Services PMI Q3-Q4 2018



Avg. = average, PMI = Purchasing Managers' Index, UK = United Kingdom, US = United States.
Notes: 50+ represents an expansion in the manufacturing and services sectors compared to the previous month. Services sector data for the US refer to the non-manufacturing sector.
Source: Markit Economics.

In the East Asia region, Q3 GDP growth was slower than Q2 for most countries. The year-to-date growth rate was higher than 2017 growth for India, Viet Nam, Thailand, and Indonesia.

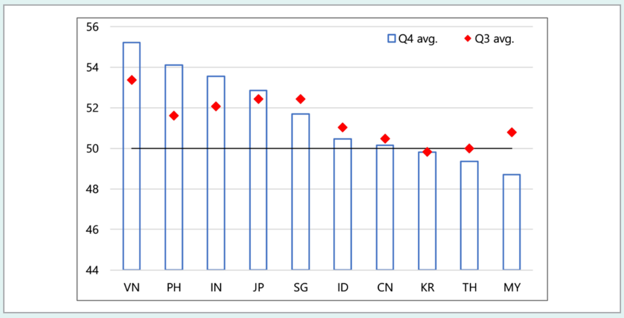
Figure 3. Annual Real GDP Growth Rates in East Asian Countries (%)



Avg. = average, CN = China, ID = Indonesia, IN = India, JP = Japan, KR = Republic of Korea, MY = Malaysia, PH = Philippines, SG = Singapore, TH = Thailand, VN = Viet Nam.
Source: CEIC Database.

For Q4, the manufacturing PMI shows that economic expansion was unbalanced across countries. The expansion was quite strong in Viet Nam, the Philippines, and India, while contractions were recorded in Malaysia and Thailand.

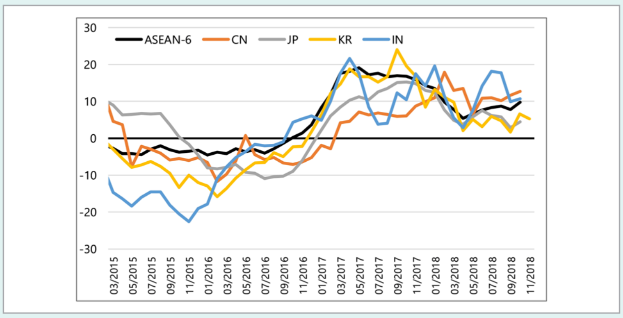
Figure 4. East Asia Manufacturing PMI Q3-Q4 2018



Avg. = average, CN = China, ID = Indonesia, IN = India, JP = Japan, KR = Republic of Korea, MY = Malaysia, PH = Philippines, PMI = Purchasing Managers' Index, SG = Singapore, TH = Thailand, VN = Viet Nam. Note: 50+ represents an expansion in the manufacturing sector compared to the previous month.
Source: Markit Economics.

After relatively weaker exports performance in Q3, the exports growth rate in Q4 does not appear to have had a significant turnaround.

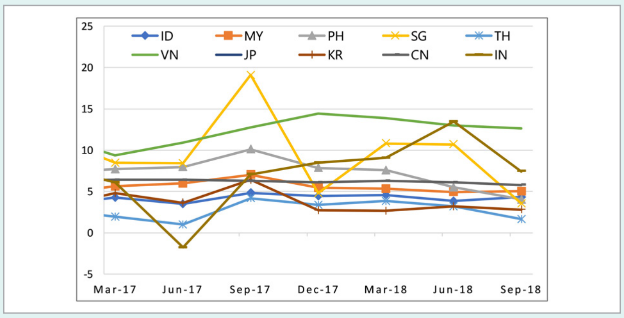
Figure 5. East Asia Exports Value Growth Rates (3-month moving average, year-on-year %)



CN = China, IN = India, JP = Japan, KR = Republic of Korea.
Note: The values for ASEAN-6 are the simple averages of the growth rates for Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam.
Source: CEIC Database.

Manufacturing value added growth slowed in Q3 in most countries, continuing the trend in Q2. The slowdown was particularly significant for Singapore and India.

Figure 6. Manufacturing Value Added Growth Rate in East Asia (real year-on-year %)



CN = China, ID = Indonesia, IN = India, JP = Japan, KR = Republic of Korea, MY = Malaysia, PH = Philippines, SG = Singapore, TH = Thailand, VN = Viet Nam.
Source: CEIC Database.

Korea, new export orders dropped the most in 5 years, and business confidence fell to a two-year low.

Slowing exports growth rates in Q4 appear to have continued to drag growth in most countries. After relatively weaker export performance in Q3, the exports growth rate in Q4 did not appear to have a significant turnaround. **Figure 5** shows that (nominal) exports growth was around 10% in Viet Nam, Singapore, China, Indonesia, and India in October, relatively similar to Q3 growth. Meanwhile, the growth rate was relatively minor in the Philippines, Thailand, and Japan. Going into November, the available data show that the exports growth rate slowed in Viet Nam and Korea.

For the manufacturing sector, value-added growth slowed in Q3 for most countries, continuing the trend in Q2. **Figure 6** shows that the slowdown was particularly significant in Singapore and India. In Singapore, Q3 manufacturing value added growth was 4% (yoy), lower than 11% in the previous quarter. This was partly due to the base effect and weaker global demand. Similarly, in India, the growth rate slowed to 7% from 14% in the previous quarter. In the Philippines and Thailand, it declined by 1.5 and 1.6 percentage points, respectively. In Indonesia, growth slightly increased by 0.5 percentage points, and in Viet Nam, the growth rate remains robust at around 13%. Strong growth in Viet Nam was supported by buoyed foreign direct investment into the manufacturing sector. Overall, despite its importance traditionally in driving productivity growth and providing employment in the region, growth in the sector was not a significant pickup for most countries.

Overall, for 2018, the economic growth rate in the region is expected to be slightly lower than 2017 growth and lower than the projection made in early 2018. This is in line with an overall weaker growth outcome globally. Compared to 2017, 2018 growth is expected to be stronger for India, Viet Nam, Thailand, and Indonesia, but weaker for China, Japan, Korea, Malaysia, and the Philippines. Despite the deceleration in China and the Philippines, the growth rate in these economies remains strong at above 6%, along with India and Viet Nam. Furthermore, despite the deceleration, economic performance in the East Asia region remains better than other regions globally.

Recent Developments in Financial Markets

Financial markets across the globe were relatively more volatile in Q4 2018 compared to Q3. The measure of volatility in the US stock market, the Chicago Board Options Exchange Volatility Index (VIX), in **Figure 7** shows that volatility increased in early October and since then has moved with a larger standard deviation after a relative calm since mid-2018. The index also shows a sharp increase in mid-December, reflecting market reaction to policy rate increase by the US Federal Reserve (the Fed) and uncertainty surrounding partial US government shutdown. The policy rate hike in December 2018 has long been anticipated by the market participants, but concerns over a slowing global economy and continued trade tension has led the market to expect the Fed to slow its monetary policy tightening. **Figure 8** shows that the stock indices in both the US and emerging markets fell sharply in early October and have moved with high volatility since then. This was followed by a sharp decline in mid-December. The S&P 500 in the US has recorded a 10% loss ytd (as of 23 December 2018), a sharp contrast to 12% ytd return it had before the fall in October. Stock markets in emerging market recorded a negative return of 16%. The figure also shows that during this period, the two indices moved in a relatively similar pattern, ending the asymmetric trend since mid-2018.

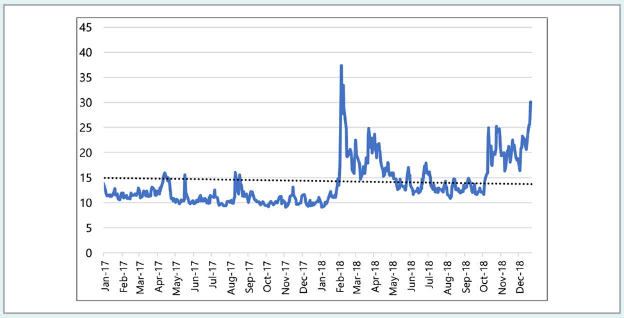
In the East Asia region, stock markets and government bond prices also generally declined, and currencies weakened against the US Dollar. Figure 9 shows stock markets in the region generally have been on diverging and declining trend since mid-2018. Indeed, **Figure 10** shows that most stock markets in the region recorded losses. Korea, China, and Japan recorded the biggest losses at 15%, 15%, and 12% ytd (as of 23 December 2018), respectively. Similarly, as **Figure 11** shows, government benchmark 10-year bond yields also increased in most countries, with the largest increases recorded in Indonesia and the Philippines at 165 basis points (bps) and 155 bps, respectively. This reflected declining prices in government bonds due to capital outflows and tightening in monetary policy. Accordingly, most currencies in the region depreciated against the US dollar. **Figure 12** shows the largest depreciation was recorded in Australia at around 10% ytd, followed by India and Indonesia at around 9% and 7%, respectively.

In responding to the volatility, some central banks in the region increased their policy rates in Q4, while others reduced their reserve requirements to stimulate growth. The central banks in Indonesia, the Philippines, and Korea raised their rates in November by 25bps, bringing their total tightening in 2018 to 175bps for Indonesia and the Philippines and 25bps for Korea. In Indonesia, the unexpected rise was motivated by government efforts to reduce the current account deficit to around 2.5% of GDP in 2019 from around 3% in 2018 as well as to anticipate global rate tightening and to stabilise the domestic currency. In the Philippines, the decision was primarily driven by an increase in inflation, expected to be 5.3% in 2018. Meanwhile, in Korea, the first rate increase in a year was intended to reduce the interest rate gap between Korea and the US as well as to contain increasing household debt. Meanwhile, in China, to stimulate growth in the midst of escalating trade tensions with the US, the central bank reduced the reserve requirement for commercial banks by 100bps in October, bringing the total cut in 2018 to 250bps. Nonetheless, in general, despite the volatility, East Asian countries were able to maintain macroeconomic stability, particularly compared to other emerging market economies. This relative success might prove critical in facing continued economic shocks in 2019.

Panel 2. Recent Financial Developments

The measure of volatility in the US stock market, the Chicago Board Options Exchange Volatility Index (VIX), shows that US markets were quite volatile in Q4 after relative calm from mid-2018. The index increased sharply in mid-December.

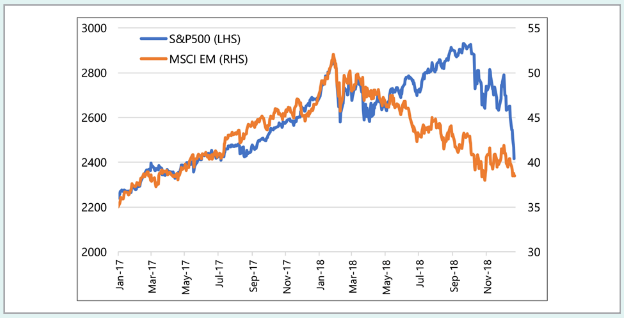
Figure 7. VIX



Source: Retrieved 23 December 2018, from https://www.investing.com/

Stock indices in both the US and emerging markets fell significantly in early October and mid-December. The two indices moved in the same pattern in Q4, ending the months of divergence from mid-2018.

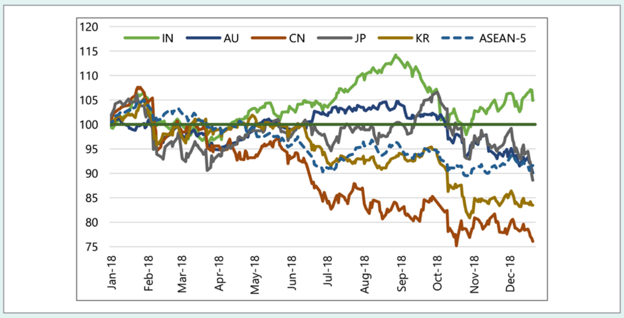
Figure 8. Global Stock Market Index



LHS = left-hand side, MSCI EM = Morgan Stanley Capital International Emerging Markets, RHS = right-hand side, S&P = Standard and Poor's.
Source: Retrieved 23 December 2018, from https://www.investing.com/.

Stock markets in East Asia have been on a diverging trend across countries since early June 2018.

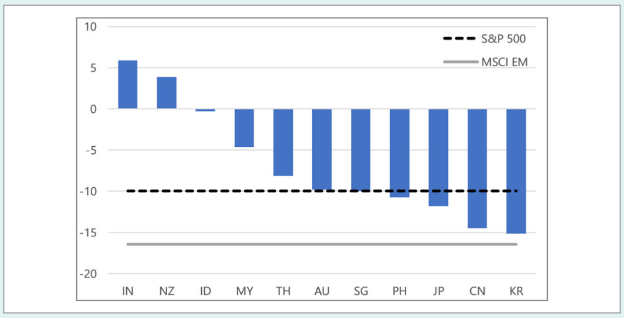
Figure 9. Stock Market Index in East Asia (29 December 2017 = 100)



AU = Australia, CN = China, IN = Indonesia, JP = Japan, KR = Republic of Korea.
Note: ASEAN-5 is the simple average of Indonesia, the Philippines, Malaysia, Thailand, and Singapore.
Source: Retrieved 23 December 2018, from https://www.investing.com/.

Most stock markets in the region recorded losses. The Republic of Korea, China, and Japan recorded the biggest losses.

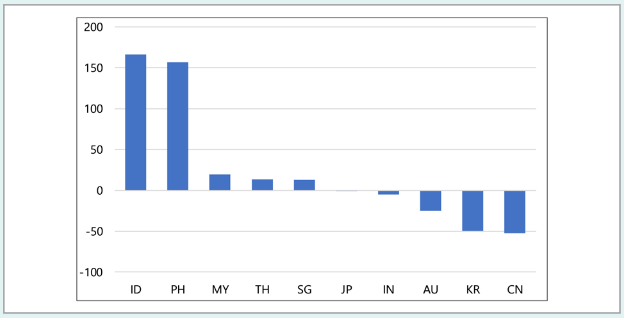
Figure 10. Stock Market Return in East Asia, 2018
(year-to-date %)



AU = Australia, CN = China, ID = Indonesia, IN = India, JP = Japan, KR = Republic of Korea, MSCI EM = Morgan Stanley Capital International Emerging Markets, MY = Malaysia, PH = Philippines, S&P = Standard and Poor's, SG = Singapore, TH = Thailand, NZ = New Zealand.
Note: Data are as of 23 December 2018.
Source: Retrieved 23 December 2018, from https://www.investing.com/.

Bond yields increased quite sharply in Indonesia and the Philippines, reflecting declining prices in government bonds due to capital outflows and monetary policy tightening.

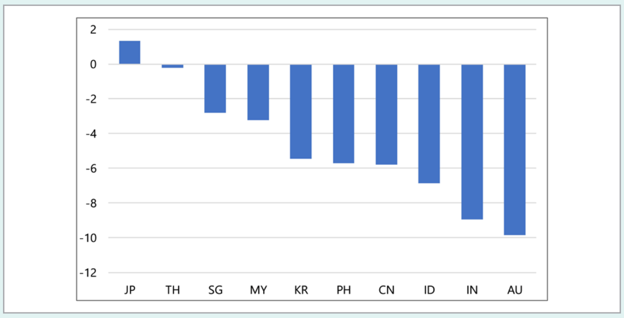
Figure 11. Changes in Benchmark 10-year Bond Yields
(year-to-date basis points)



AU = Australia, CN = China, ID = Indonesia, IN = India, MY = Malaysia, PH = Philippines, SG = Singapore, TH = Thailand.
Note: Data are as of 23 December 2018.
Source: Retrieved 23 December 2018, from https://www.investing.com/

All currencies in the region depreciated against the US dollar. Australia, India, and Indonesia recorded the largest depreciations.

Figure 12. Changes in Foreign Exchange Rates per US Dollar
(year-to-date %)



AU = Australia, CN = China, ID = Indonesia, IN = India, JP = Japan, KR = Republic of Korea, MY = Malaysia, PH = Philippines, SG = Singapore, TH = Thailand. Notes: Positive values denote currency appreciations. Data are as of 23 December 2018.
Source: Retrieved 23 December 2018, from https://www.investing.com/.

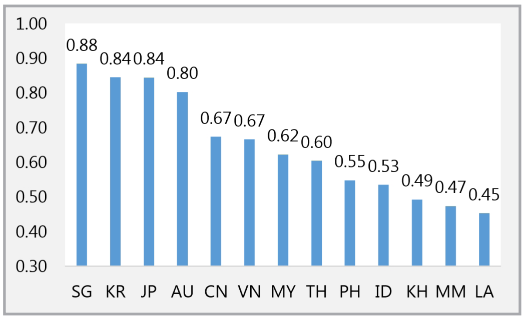
Outlook and Risk in 2019

The economic outlook for 2019 remains overshadowed by the continuation of various shocks affecting economic performance in 2018. As noted above, 2018 economic performance both globally and in the region was lower than 2017 growth and its projection at the beginning of 2018. The reverse in the optimism can be attributed to various shocks, which are expected to continue to pose downside risks for the 2019 outlook. The risks are as follows. First, intensified trade tensions. Despite the agreement between the US and China to cease further raises in tariffs for 90 days, the existing tariffs have negatively affected trade, and the uncertainty about further developments remains. Second, continued uncertainty about Brexit. As the final date of Brexit approaches, the uncertainty surrounding Brexit has intensified and negatively affected investment and business confidence both in the UK and Europe. A disorderly no-deal Brexit, which remains a distinct possibility, could result in significant harm to the region. Third, faster than expected US monetary tightening and macroeconomic instability in some emerging market economies. Continued policy rate hikes and unsettled cases of macroeconomic instability in some emerging markets, for instance in Argentina and Turkey, could increase overall risk perceptions of emerging markets, thus affecting the flow of capital. Fourth, country-specific shocks. The outlook remains clouded by country-specific shocks, for instance the deleveraging drive in China, macroeconomic instability in Venezuela, and natural disasters, amongst many others, which derailed economic performance in 2018. Addressing these risks requires agility, continued focus on maintaining macroeconomic stability, and policies to push potential growth. Policies to push potential growth would put policymakers in an 'offensive' stance, rather than the continued 'defensive' stance of maintaining macroeconomic stability.

Improving potential growth largely depends on improving human capital. Economic potential is mainly determined by the technology or productive capacity of the economy, which in itself fundamentally depends on human capital. The World Bank's human capital project identifies human capital components as people's skills, health, knowledge, and resilience. Improving these aspects would enable people to be more productive, flexible, and innovative in facing the rapidly changing nature of work. According to the World Bank's Human Capital Index, there are large differences in human capital quality across countries in the region. The index measures the current human capital situation relative to its full potential (complete education and full health). A score of 0.5, for instance, means the country could have per capita income twice as high as the status quo if its citizens were to receive complete education and health. This could translate to additional economic growth of 1.4 percentage points over a 50-year period.

Figure 13 shows the human capital index across countries in the region. It shows that significant gaps remain between high-income and middle-income countries. In countries such as Indonesia, Cambodia, Myanmar, and Lao PDR, if other things remain constant, children born today could have earned twice their income per capita in the future had their human capital been realised to its full potential. This constitutes a significant increase in potential growth. There is significant room for improvement in many areas across countries in the region. Amongst others is the quality of education. In Indonesia, for instance, the expected number of school years in the country is 12.3 years, but when adjusted for quality, this equals only 7.9 years, i.e. 65% of the actual number of school years. The same issue can be found in Myanmar, the Philippines, and to some extent Thailand. In conclusion, in addition to a short-term policy response, such as preserving macroeconomic stability, policymakers in the East Asian region need to improve their effectiveness in improving human capital. Through a combination of short-term and long-term strategies, a more resilient region can be achieved.

Figure 13. Human Capital Index in East Asia



AU = Australia, CN = China, ID = Indonesia, JP = Japan, KH = Cambodia, KR = Republic of Korea, LA = Lao PDR, MM = Myanmar, MY = Malaysia, PH = Philippines, SG = Singapore, TH = Thailand, VN = Viet Nam.
Source: The Human Capital Project, World Bank.

For more information, please contact:
Rully Prassetya (rprassetya@gwu.edu)

ERIA Economic Research Institute for ASEAN and East Asia

Sentral Senayan 2, 5th and 6th floors
Jalan Asia Afrika No.8
Senayan, Central Jakarta 10270, Indonesia
Tel: (62-21) 57974460
Fax: (62-21) 57974463
E-mail: contactus@eria.org