EAST ASIA
UPDATES

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Sailing through Volatility

The full year realisation of 2017 global gross domestic product (GDP) growth matches the expectation at the end of 2017. Furthermore, the global economy appears to have continued to expand in the first quarter of 2018. This also applies to the East Asian region, although some developments at the start of the year warrant closer attention. As the governments of the region continue with their tasks of improving competitiveness and productivity, external risks to economic and financial conditions have increased in recent months. These include changing expectations about monetary policy tightening in advanced economies and recent protectionist trade measures taken by the United States (US) government. Economic expansion in the US has triggered higher inflation expectations and thus expectations of a faster policy rate normalisation. Recent trade measures by the US government have also created uncertainty about the outlook for international trade and may affect countries in the region directly and indirectly. In addition to accelerating structural reform in their domestic economies, now more than ever, national governments in the East Asian region need to strengthen global and regional cooperation to manage the uncertainty.

First Quarter Economic Performance

The full year realisation of 2017 GDP growth in advanced economies matches the expectations at the end of 2017 and the global economy continued to show expansion in the first quarter of 2018. The US and euro area economies grew by 2.3% in 2017. This is particularly strong for the euro area, where the past 3 years' average was only 1.7%. Furthermore, the growth rate of both economies in the last quarter of 2017 (at 2.5% and 2.7% for the US and euro area, respectively) was also higher than the full year realisation showing a strong trajectory entering 2018 **(Figure 1)**. Import volume growth in advanced economies continued to show stable growth until the end of 2017, reflecting relatively strong domestic demand. Global economic growth in the first quarter of 2018 still shows signs of expansion. For instance both the manufacturing and services Purchasing Manager Index (PMI), despite showing deceleration in March, are still above the threshold, pointing to further expansion in Q1 **(Figure 2)**.

For the East Asian region, the full year realisation of 2017 GDP growth also met expectations. Some countries, such as India, Indonesia, Thailand, and Viet Nam, showed relatively robust growth in the last quarter of 2017 **(Figure 3)**. India grew by 7.2% in Q4, making it the fastest growing large economy in Q4 2017. This was particularly supported by strong investment growth (at 12%) and government consumption growth (at 6%). Indonesia also recorded strong GDP growth in Q4 2017, at 5.2%, bringing its 2017 GDP growth to 5.1%, the highest since 2014. The Q4 growth was also supported by strong investment growth (of 8.4%), offsetting relatively subdued private consumption growth, which remained below 5%. Thailand's Q4 GDP growth rate of 4% was also backed by a strong investment growth rate of 9.3%. In fact, its 3.9% overall growth rate in 2017, the highest since 2013, was mainly driven by more than 14% growth in investment. Fourth quarter GDP growth in other countries, for instance Singapore, Malaysia, Japan, the Republic of Korea, and the Philippines, was slightly slower than their Q3 growth, but their overall 2017 GDP growth remained stronger than their past 3 years' averages. In Singapore, Q4 GDP growth slowed to 3.6% from 5.5% in Q3 due to slower investment, government consumption, and exports growth. Nonetheless, its overall 2017 GDP growth of 3.6% is well above the past 3 years' average of 2.8%. Similarly, in Japan, Q4 GDP growth slowed to 1.5% from 1.9% in Q3 due to stronger imports growth. Its overall 2017 growth rate of 1.6% remains above the past 3 years' average of 0.9%. In the Republic of Korea, Q4 GDP growth slowed to 3% from 3.8% in Q3 2017 due to slower investment growth and a contraction in exports growth. Its 2017 GDP growth of 3.1% is also slightly higher than the past 3 years' 3.0%. Overall, 2017 was a good year for most countries in the region due to higher investment and government consumption growth, on the back of stable private consumption. However, their dependence on exports is quite apparent as a slowdown in exports growth in Q4 was clearly reflected in lower GDP growth.

In the first quarter of 2018, the region's economy showed signs of continued expansion, but there are several early signs pointing to a deceleration. As Figure 4 shows, the manufacturing PMI in most countries is still showing expansion, albeit not particularly strong as the values are mostly close to the threshold 50. Some countries, for instance the Philippines, the Republic of Korea, and Malaysia recorded manufacturing sector slowdown in March. Meanwhile, the export growth rate appears to have slightly slowed in most countries, particularly in India, Japan, and Southeast Asian countries (Figure 5). Prices of important commodity prices for the region, such as rubber and palm oil, continue to decline. Meanwhile copper price growth rate also continue to moderate. Higher budget deficits in some countries as a result of their governments' efforts to accelerate public investment have contributed to higher trade deficits and a weakening of their currencies. Inflation has also picked up in some countries, such as the Philippines and India. This raises questions about the sustainability of growth strategies through higher public consumption and public investment in some countries. Furthermore, the long-standing issue of moderate manufacturing value added growth remains as no notable improvement was seen in Q4. Most countries recorded slightly lower manufacturing growth in Q4 compared to Q3. And in Singapore manufacturing growth fell from 19% in Q3 2017 to 5% in Q4 **(Figure 6).**

In view of the domestic challenges described above, external risks to economic activity have risen, especially in trade and on the financial front. On the trade front, 2018 appears to be the year of higher protectionism. President Trump is sticking to the promises of his election campaign with a series of tariff measures since the start of the year. This has created uncertainty, leaving it unclear, for instance, whether these tariffs are the beginning of a campaign of wider protectionist measures, how America's trading partners will react, how the existing multilateral trade system will address the issue, and how it will affect trade flow going forward. This will be discussed further in the next section below.

On the financial front, expectations of a tightening of monetary policy by advanced economy central banks have risen, creating volatile financial conditions. Higher than expected wage growth in the US coupled with low unemployment (at 4%) in early February triggered concern amongst market participants that the US economy might be close to full capacity. Together with a weak dollar, this is believed to prompt the Federal Reserve (the Fed) to tighten monetary policy faster than expected. Furthermore, tax cuts in late 2017 also risk causing the economy to overheat, giving the Fed even more reason to tighten. Indeed, market participants now expect the Fed to increase policy rates four times in 2018 rather than the three times previously expected. Following the news, stock market indices fell (Figure 7) and the VIX volatility index increased to its highest level in almost 3 years (Figure 8). The 10-year treasury bills bond yield also increased sharply to around 2.9%, the highest in 4 years.

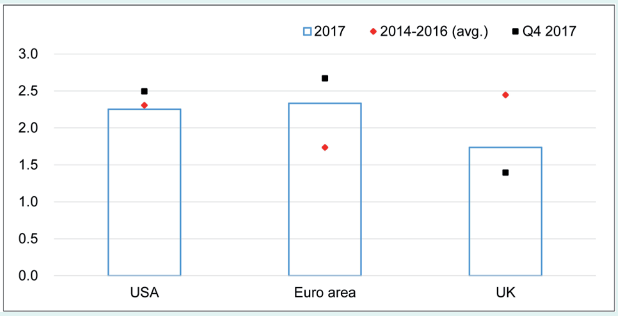
As financial markets are highly interconnected, the markets in the East Asia region have been affected by the higher uncertainty. Stock indices in the region have been falling since early February and have been on a volatile trajectory since then (Figure 9). Even though many of the indices reached all-time highs in January, most of the gain was reversed, leaving many countries with negative year-to-date returns (Figure 10). Due to the fiscal and current account deficits, the US Dollar has weakened. Nevertheless, some currencies in the region (e.g., the Philippine peso, the Indian rupee, and the Indonesian rupiah) have continued to depreciate against the US dollar, highlighting their vulnerability to volatile financial conditions (Figure 11). Finally, government bond yields have also increased, particularly in Indonesia, Singapore, the Philippines, and India (Figure 12) This reflects declining bond prices driven by capital outflow from the bond market. Continued volatility in the financial market would affect business and investment confidence, which in turn would translate into lower economic activity. In addition to higher volatility, companies in the region also face debt refinancing risk due to higher interest rates. During the low interest rate period of the past 10 years, many emerging markets, including those in the East Asian region, have accumulated large debts, many of which are held by non-residents.

As risks to domestic economic activities have increased while external economic and financial conditions have become more volatile, policy makers in the region would need to exercise greater caution in maintaining economic expansion and macroeconomic stability. During this period of high turbulence, improving domestic economic fundamentals and competitiveness remains the best cushion against volatility. In addition to domestic efforts, international and regional cooperation are necessary to restore stability. This cooperation is even more critical in addressing the recent surge in protectionist tendencies.

Panel 1. Recent Economic Developments

GDP growth realisation in advanced economies held up, with Q4 2017 GDP growth is higher than the overall 2017 growth in the US and Euro area.

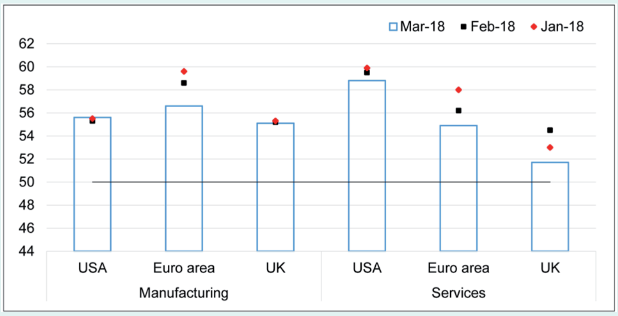
Figure 1. Annual Real GDP Growth ate in Advanced Economies (%, seasonally adjusted)



GDP = gross domestic product; avg. = average; USA: United States of America; UK = United Kingdom.
Source: OECD Statistics.

In Q1 2018, manufacturing and services sector PMI of advanced economies are still in expansionary territory. However, the expansion rate softens in March.

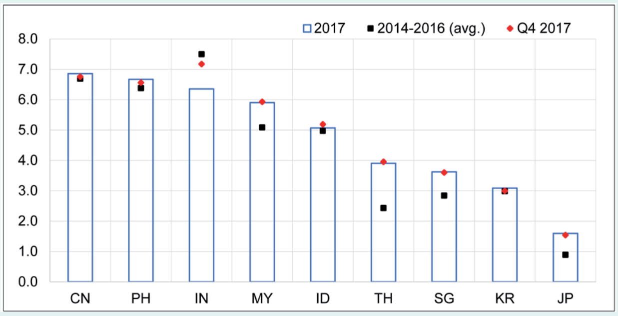
Figure 2. Global Manufacturing and Service PMI Jan-Mar 2018 Index



PMI = Purchasing Managers' Index.
Note: 50+ represents expansion of manufacturing services sector compared to the previous month. Services sector data for the USA refers to non-manufacturing sector.
Source: Markit Economics.

Q4 2017 GDP growth realisation also held up as expected among East Asian countries.

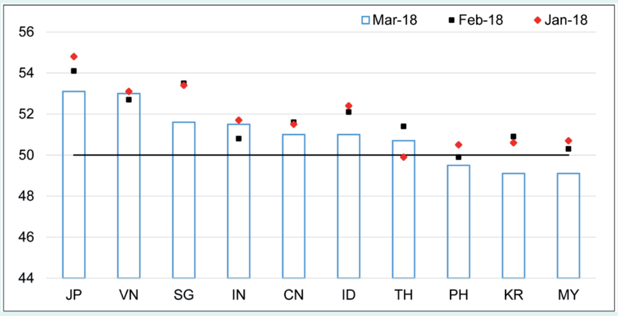
Figure 3. Real GDP Growth Rate in East Asian Countries (%)



GDP = gross domestic product; avg. = average; ytd = year-to-date. CN = China; PH = Philippines; IN = India; MY = Malaysia; ID = Indonesia; KR = Republic of Korea; SG = Singapore; TH = Thailand; JP = Japan.
Source: Author's calculation, CEIC Database.

Manufacturing PMI in most of East Asian countries is also in expansion territory during Q1 2018, however the expansion weakened in March..

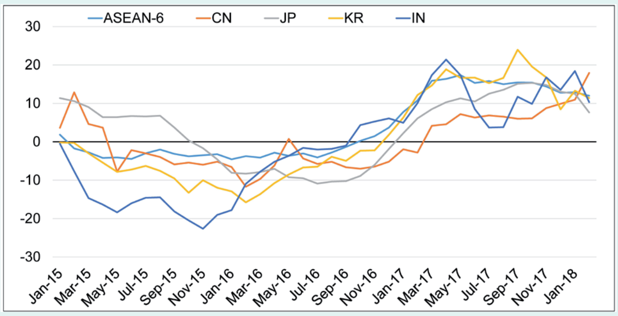
Figure 4. East Asia Manufacturing PMI Jan-Mar 2018 Index



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

Exports growth rate is still in positive territory albeit slightly slowed in Q1 2018 in most countries..

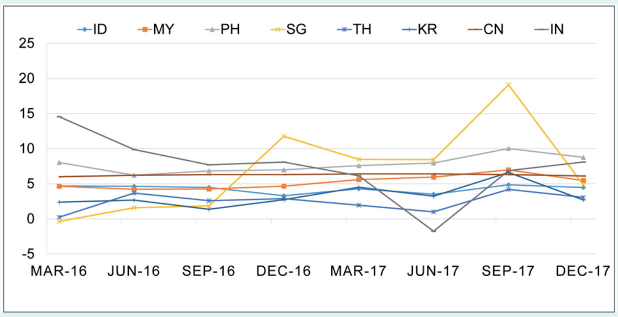
Figure 5. East Asia Export Value Growth Rate 3 mma yoy, %



CN = China; JP = Japan; KR = Republic of Korea; IN = India; 3mma yoy = 3 months moving average year-on-year.
Note: ASEAN-6 is simple average growth rate of Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam.
Source: CEIC Database.

Manufacturing sector value added growth rate in Q4 2017 was still relatively.

Figure 6. Manufacturing Value Added Growth Rate in East Asia Real, yoy, %

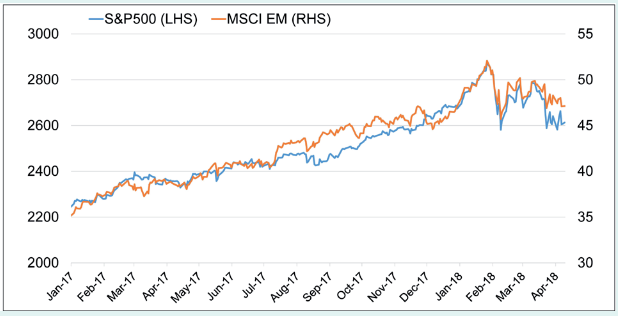


yoy = year-on-year; ID = Indonesia; MY = Malaysia; PH = Philippines; SG = Singapore; TH = Thailand; KR = Republic of Korea; CN = China; IN = India.
Source: CEIC Database.

Panel 2. Recent Financial Developments

Stock markets in advanced economies and emerging markets fell in early February and have been on volatile pattern since.

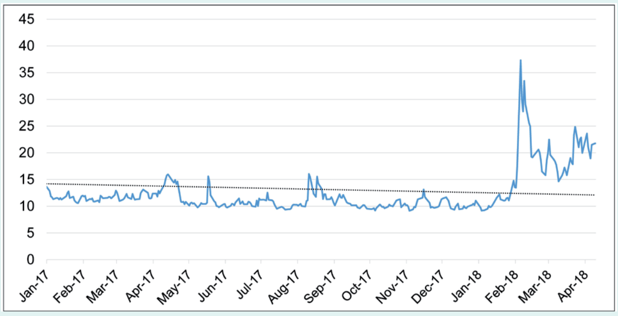
Figure 7. Global Stock Market
Index



MSCI EM = Morgan Stanley Capital International Emerging Market; ytd = year-to-date; LHS = Left had side; RHS = Right hand side. Note: as of 9 April 2018.
Source: Bloomberg, Yahoo Finance.

Measure of stock market volatility, VIX, increased sharply during the period.

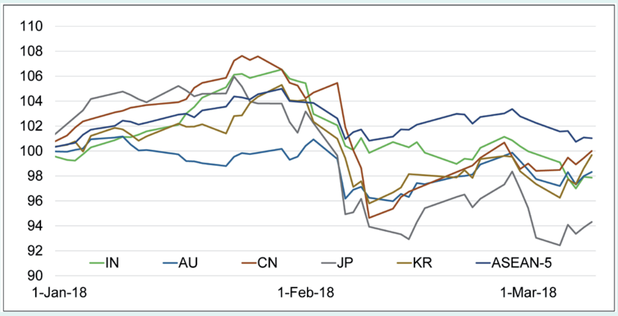
Figure 8. VIX
Index



VIX = The CBOE Volatility Index.
Source: Yahoo Finance.

Stock markets in East Asian region have been on volatile pattern since early February 2018.

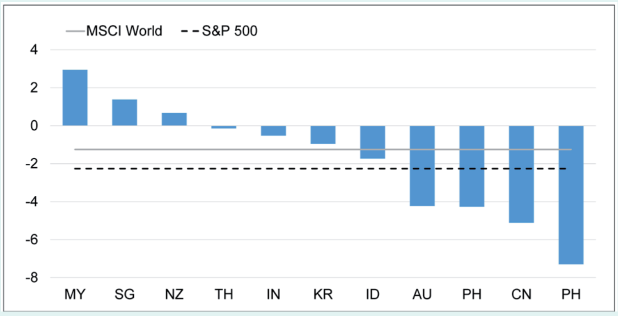
Figure 9. Stock Market Index in East Asia
(Dec 29 2017 = 100)



ASEAN-5 is simple average of Indonesia, Philippines, Malaysia, Thailand, and Singapore; IN = India; AU = Australi; CN = China; JP = Japan; KR = Republic of Korea.
Source: Bloomberg, Yahoo Finance.

Most gain in 2018 was corrected resulting in negative year-to-date return in most countries. Some countries have deeper correction than the global average.

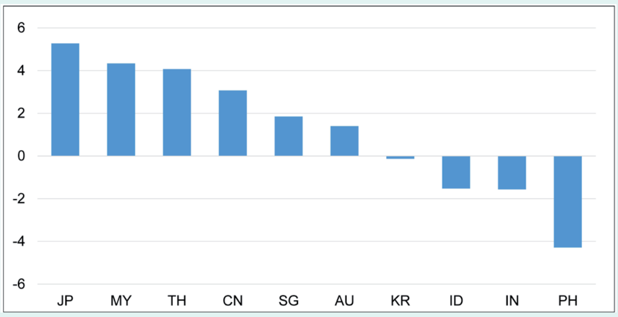
Figure 10. Stock Market Return 2018 in East Asia
ytd, %



MSCI World = Morgan Stanley Capital International World; ytd = year-to-date; IN = India; KR = Republic of Korea; PH = Philippines; NZ = New Zealand; JP = Japan; SG = Singapore; ID = Indonesia; TH = Thailand; AU = Australia; MY = Malaysia; CN = China.
Note: as of 9 April 2018.
Source: Bloomberg, Yahoo Finance.

US Dollar was generally weakened in 2018 due to twin deficit in fiscal and current account. However currency in some countries in the region are depreciated against the US Dollar.

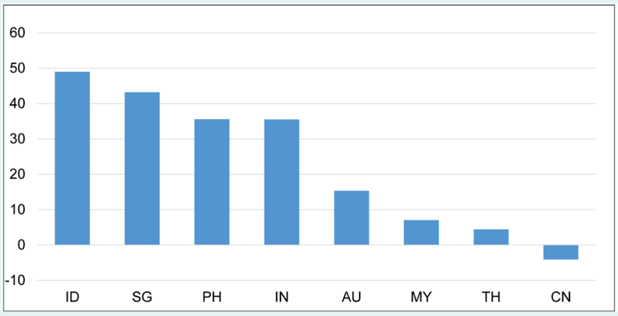
Figure 11. Change in Foreign Exchange Rate per One USD
ytd, %



ytd = year-to-date; KR = Republic of Korea; MY = Malaysia; TH = Thailand; SG = Singapore; IN = India; CN = China; JP = Japan; ID = Indonesia; PH = Philippines; AU = Australia.
Note: Positive denotes appreciation; as of 9 April 2018.
Source: Bloomberg

Bond yields have increased in all countries, reflecting declining prices in government bonds due to capital outflow.

Figure 12. Change in Benchmark 10yr Bond Yield
ytd, in bps



ytd = year-to-date; bos = basis points; IN = India; KR = Republic of Korea; PH = Philippines; NZ = New Zealand; JP = Japan; SG = Singapore; ID = Indonesia; TH = Thailand; AU = Australia; MY = Malaysia; CN = China.
Note: as of 9 March 2018
Source: Bloomberg, Yahoo Finance.

Protectionism on the Rise

Risks arising from stronger protectionist measures have increased. Several recent US trade policies reflect a stronger protectionist tendency. Policy makers around the world are faced with uncertainty about how fast and how far President Trump will go in fulfilling the protectionist promises he made during his election campaign. It has also become clear that certain companies and industry associations in the US have been successful in their efforts to persuade the administration to impose tariffs. This may suggest there will be more of these kinds of measures to come. A further escalation of protectionist measures and countermeasures could have a profound impact on the world economy, especially on a region as heavily involved in and as big a beneficiary of international trade as the East Asian region. International frameworks and domestic economic policies remain the best avenues for governments to manage trade issues, rather than through protectionist measures.

There are several recent instances of protectionist policies by the US administration. After its withdrawal from the Trans-Pacific Partnership agreement and initiating a renegotiation of the North American Free Trade Agreement in 2017, the US administration has launched several new protectionism measures since early 2018. These include imposition of tariffs on washing machines and solar panels in late January, tariffs on steel and aluminum in early March, and more recently, in early April, planned tariff on around US$50 billion worth of imports from China. Citing serious injury to domestic producers, the US has set tariff on washing machine and solar panel at 20% and 30% respectively (declined over the certain period). Citing national security concerns as justification, the US administration set tariffs on steel and aluminum at 25% and 10%, respectively. Meanwhile in response to various intellectual property and transfer of technology issues with China, the administration planned to impose 25% tariff on around 1,300 Chinese products. Moreover, top US administration officials have asserted that a weak dollar is good for US exports. Such remarks have not been well received by several US trading partners, including euro area governments, who have seen the euro appreciate by around 20% against the US dollar over the past year, thus negatively affecting their countries' export competitiveness.

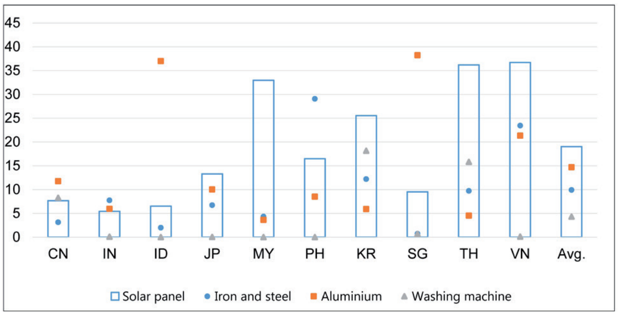
The extent of the damage from this new policy could be significant if the tension escalate further. After two weeks of uncertainty following the steel and aluminum tariff announcement, the US administration in the end temporarily exempted seven countries/region, accounting for around 70% of steel and aluminum imports, provided some of them would exercise exports restraint to the US and find alternative means to address the trade imbalances. The exemption has reduced the risk of trade war through retaliatory measures by many countries. However, already, retaliatory tariff by China, one of the countries not exempted from the tariff, has caused significant concerns among US producers and thus opening possibility of trade war among the two countries. China has imposed tariff on around 130 goods, mainly agricultural products, worth US$3 billion of US exports. Meanwhile, the planned additional tariff by the US on 1,300 goods imports worth US$50 billion from China and subsequently China's possible retaliatory measures have increased the tension further. Furthermore, as the steel and aluminum tariff exemption are still temporary, a permanent solution has yet to be found. More generally, the recent trade policies have created unfavorable precedence and might violate WTO principles thus providing significant challenge to the international trade system.

These policies will impact the East Asian region through direct and indirect effects, with the indirect effect may prove to have larger impact. The direct effect would be a reduction in the exports of affected products to the US or declining exporters' profit margins. Figure 13 shows the US share in the exports of East Asian countries for several products affected by the new tariffs. For some countries, the US accounts for as much as one-third of their exports. On average, exports to the US account for about 20% of these countries' solar panel exports, 15% of their aluminum exports, 10% of their iron and steel exports, and 5% of their washing machine exports. The Republic of Korea exports 20% of its washing machines to the US, the largest share amongst East Asian countries. It is quite understandable, therefore, that the Korean government is particularly unhappy about the new tariff and plan to suspend tariff concessions on imported US goods as a form of retaliation. The indirect effect could take several forms that may be quite notable and has larger impact than the direct effect. The first form would be disruptions to countries involved in the production networks of the affected products. The number of countries affected would grow if the announced tariffs on 1,300 Chinese exports take effect. The second form could be market or price disruptions due to the reallocation of excess production to other countries. Countries with excess production may redirect their exports to other countries, thereby disrupting the existing market. Imposition of tariffs by the new destination countries could exacerbate the situation. Finally, it could be in the form of overall economic slowdown in China, a country appears to the main target of several new policies by the US administration. Given the importance of Chinese economy to the economy of East Asian countries, its slowdown is expected to negatively affect external demand in region.

The US is among major exports destination for East Asian countries in select product categories affected by the new tariffs imposed by the US administration.

Figure 13. Share of the US in East Asian countries exports in 2016

%



Note: SITC erv.3 code: Iron and Steel (67); Aluminium (684); Household laundry equip. (7751); Diodes, transistors, etc. (7763).
Source: UN Comtrade database, accessed 12 March 2018.

The concern that the prevailing international trade system has led to job dislocation and rising inequality warrants correction to the system. Nonetheless, the attempted quick fix through imposing tariff will do more harm than good. It could lead to trade war resulting in a lose-lose situation. A better approach to correct the negative impact of international trade should be implemented through multilateral efforts combined with domestic policies that improve competitiveness and labor productivity. In terms of multilateral efforts, a functioning WTO is critical for a multilateral rule-based trading system. The fact that the WTO may have some deficiencies should be admitted and the international community should be open about how to improve it. Beyond the WTO, it is essential for all countries to work together in addressing various concerns (e.g., currency manipulation concern and excess capacity) through the multilateral framework. The Group of 20 global forum on steel excess capacity is a good example of multilateral efforts in managing trade friction. On domestic policy, each country should continue to improve the competitiveness of its business environment and improve labor productivity through education and training programmes. An employee retraining programme and financing programme for small and medium enterprises could be set up to mitigate any job dislocation that may arise. In addition, it is worth noting that President Trump's big concern of the size of the US trade deficit should be put in the context of wider US economic policy. A large fiscal deficit policy by the current US administration on the back of tax cuts and large public investment makes a deterioration in the external trade balance highly likely. As a result, having aligned policy objectives could also prevent introduction of unsuitable policy responses such as the current protectionist measures. Finally, as any crisis always also brings opportunities, the recent surge in protectionist measures and its repercussions may in the end remind all countries of the importance of the multilateral rule-based trading system and international cooperation. It is in everyone's interest to correct the deficiencies in the current multilateral set up rather than undermine it.

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