EAST ASIA
UPDATES

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Continued Volatility and Uncertainty

The challenging economic conditions in the second quarter (Q2) of 2018 continued into the third quarter (Q3). Economic performance in advanced economies remains on two speeds: the United States (US) has continued to grow at a faster pace, while the eurozone is showing early signs of deceleration. In the East Asian region, the Q2 gross domestic product (GDP) growth rate in most countries was slow compared to the first quarter (Q1), driven mainly by a deceleration in exports. The Q3 manufacturing Purchasing Manager Index (PMI) for the region does not indicate a substantial turnaround in economic activity. Deceleration in the export growth rate appears to have bottomed out at the middle of Q2, however there is no sign of a firm pickup. Capital outflows from emerging markets and the strengthening of the US dollar also continued during Q3 in addition to uncertainty in international trade. These developments have affected countries in the region to varying degrees, depending on their overall economic fundamentals. Emerging market economies in the region with current account deficits have been affected more. However, they have rightly prioritised macroeconomic stability over growth by allowing their exchange rates to adjust, increasing their interest rates, and implementing policies for reducing imports. Going forward, as many countries in the region are negatively affected by declining exports growth, the continuation of trade tensions, a weaker outlook amongst major trading partners, and tightening monetary policy might result in a further drop in business confidence and moderation in growth. This could cause the synchronised and long-awaited recovery of 2017 to be short-lived.

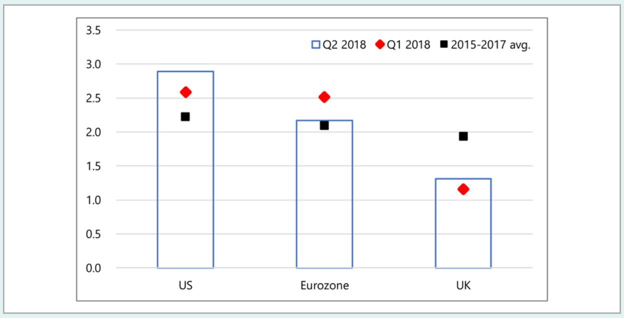
Recent Economic Performance

Economic performance in advanced economies remains on two speeds. The US economy continues to grow, while growth in the eurozone has decelerated. **Figure 1** shows that after recording 2.6% year-on-year (yoy) growth in Q1, higher than its 3-year average during 2015–2017 of 2.2%, US economic growth continued to accelerate, with 2.9% yoy growth in Q2, its highest rate in 3 years. This was spurred by higher household consumption and a higher exports growth rate. A sizeable tax cut at the end of 2017 translated into higher consumer spending. Nonetheless, the sustainability of the high growth is uncertain as it was driven by tax cuts and a higher fiscal deficit rather than an underlying improvement in productivity. Meanwhile, in the eurozone, the recovery might be short-lived as its Q2 growth rate of 2.2% yoy was lower than the Q1 rate of 2.5%, in line with its previous 3-year average of 2.1%. This was driven by weak exports and lower domestic demand due to lower business confidence and reduced international trade. There was heterogeneity across member countries as Italy and Spain recorded lower growth due to subdued exports, while Germany posted stronger growth due to its robust domestic economy. For the United Kingdom (UK), the situation has not improved, as its Q2 economic growth of

Panel 1. Recent Economic Developments

During Q2 2018, the annual GDP growth rate in the US remained higher than in the previous quarter. Meanwhile, the rate decreased in the eurozone and was relatively unchanged in the UK.

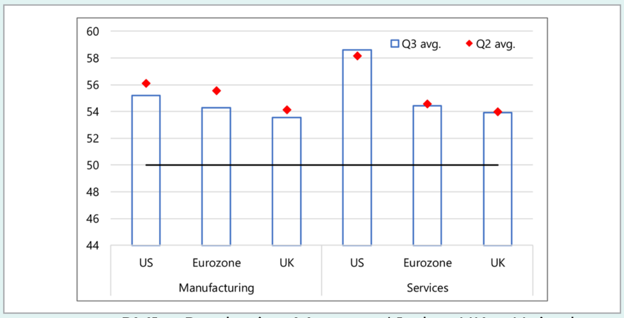
Figure 1. Annual Real GDP Growth Rate in Advanced Economies (%, seasonally adjusted)



avg. = average, UK = United Kingdom, US = United States
Source: OECD Statistics.

In Q3, the manufacturing and services PMI was still increasing in advanced economies, athough at a slower rate than during Q2 in manufcaturing and in line with the Q2 rate in the services sector.

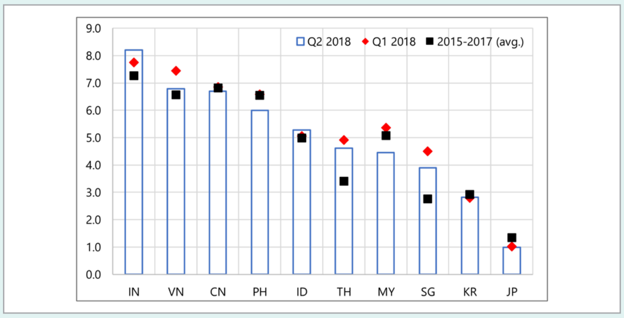
Figure 2. Global Manufacturing and Services PMI Q2–Q3 2018



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

In the East Asian region, the Q2 GDP growth rate was slightly slower than during Q1 for most countries, except India and Indonesia.

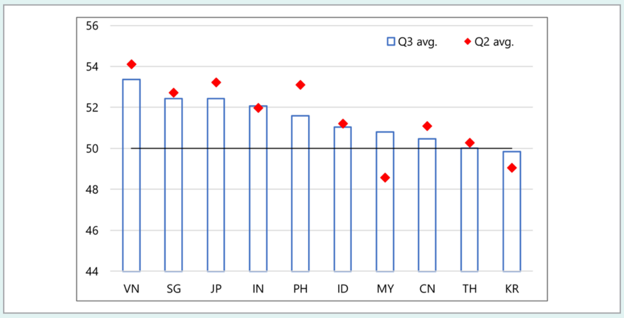
Figure 3. Annual Real GDP Growth Rate in East Asian Countries (%)



GDP = gross domestic product, 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.

The manufacturing PMI shows that economic activity in the region still expanded during Q3. However, there were no signs of a substantial reversal from the deceleration of the previous quarter.

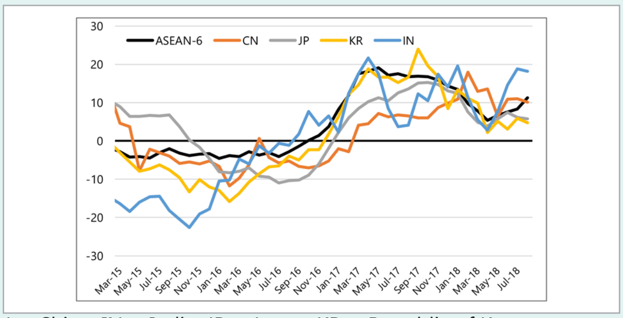
Figure 4. East Asia Manufacturing PMI Q2–Q3 2018



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.
Note: 50+ represents expansion in the manufacturing sector compared to the previous month.
Source: Markit Economics.

Export growth rates did not show firm signs of picking up in Q3 despite the decelerating trend appearing to have bottomed out in the middle of Q2.

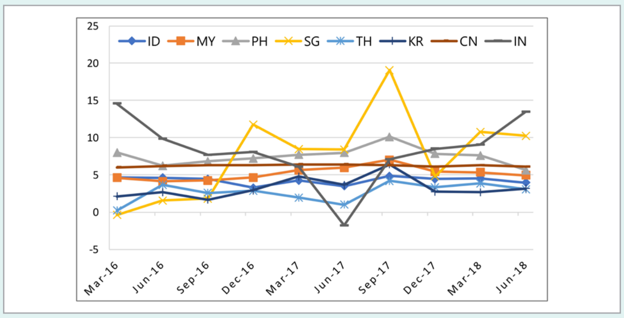
Figure 5. East Asia Export Value Growth Rates (3-month moving average, year-on-year %)



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

Manufacturing value added growth slowed in Q2 in most countries, except India and Korea. The slowdown was particularly significant for the Philippines, followed by Thailand and Indonesia.

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



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

1.3% yoy was nearly the same as its Q1 rate of 1.2%, much lower than its 3-year average of 1.9%. This suggests the country might have been caught up in a low growth situation as uncertainty still looms following the Brexit vote of 2016. Turning to Q3, as Figure 2 shows, the manufacturing sector PMI is still expanding in advanced economies despite the expansion being slightly slower compared to the Q2 rate. Meanwhile, the service sector has also continued to expand significantly, in line with the previous quarter's expansion. The expansion of the service sector in the US was particularly strong due to stronger construction, transport, and retail trade activity.

In the Southeast Asia region, in most countries, the Q2 GDP growth rate was slightly lower than the Q1 growth rate. Figure 3 shows that the slowdown was relatively strong in Malaysia, Viet Nam, Singapore, and the Philippines. A common denominating factor in most countries was the slowdown in the export growth rate along with an increase in the import growth rate due to higher investment. This resulted in a negative contribution of net exports to GDP growth. Of the group, only Indonesia managed to grow more strongly in Q2 at 5.3% yoy compared to 5.1% in Q1, its highest growth rate since 2014. This was supported by stronger government consumption growth and a pickup in household consumption. Investment growth also remained steady at around 8%, continuing the trend of the past 3 quarters. However, the contribution of net exports to GDP growth continued to be negative due to a strong (real) import growth rate of 15%, higher than its export growth rate of 8%. In Malaysia , the GDP growth rate fell relatively sharply from 5.4% in Q1 to 4.5% in Q2. This brought GDP growth below its 3-year average for 2015–2017 of 5.1%. In fact, GDP growth slowed for three consecutive quarters. The latest slowdown was due to an increase in the import growth rate on the back of a falling export growth rate, resulting in a drop in the contribution of net exports to GDP growth. Meanwhile, the contraction in the investment growth rate softened from –9% in Q1 to –1% in Q2. The plan by Malaysia's newly elected prime minister to review infrastructure projects initiated by the previous administration, however, might limit the investment growth rate in the near term. Similarly, in Viet Nam, the GDP growth rate also fell considerably from 7.5% in Q1 to 6.8% in Q2. This was, however, still a relatively strong growth rate and still higher than its 3-year average of 6.6%. A deceleration in the export growth rate also contributed to the slowdown. In the 4 quarters leading up to Q2 2018, Viet Nam's (nominal) export growth rate was consistently above 20%. However, the impressive growth ended in Q2 2018 and even fell to 9% in June. In the Philippines and Singapore, the GDP growth rate fell by around 0.6 percentage points in Q2. In the Philippines, it fell from 6.6% in Q1 to 6.0% in Q2, bringing it below its 3-year average of 6.5%. Although the Philippines' (real) exports grew robustly in Q2 at 13%, up from 6% in Q1, its imports growth rate increased even more strongly to 20%, from 10% in Q1. This resulted in a negative contribution of net exports to GDP growth. Along with higher imports, the investment growth rate increased significantly to 21% from 12% in the preceding quarter. In Singapore , the GDP growth rate fell from 4.5% to 3.9%. This was still higher than its 3-year average of 2.8%. The slowdown was driven by slower household and government consumption growth. The contribution of net exports to growth also fell as a result of a faster increase in imports growth compared to the increase in exports growth. Finally, in Thailand , economic growth also slowed, although to a lesser degree, from 4.9% to 4.6%. This was still higher than its 3-year average of 3.4% and driven by a slowdown in the investment growth rate from 17% to 10% and a slowdown in government consumption from 1.9% to 1.4%. Stricter government procurement rules introduced in 2017 also contributed to the slowdown. Higher exports growth, however, managed to offset some of the impacts of the slowdown. Overall, the slowdown in GDP growth in most countries in the region could not be separated from the slowing export growth rate and GDP growth moderation in their major trading partners, particularly in other East Asian countries.

In other East Asian countries, economic growth rates in Q2 also fell compared to Q1. India managed to increase its growth, but the growth rates of the Republic of Korea (henceforth, Korea) and Japan remained broadly unchanged, while China's growth rate slowed slightly. In *India*, economic growth reached 8.2% yoy growth, its highest rate in 2 years. This was significantly higher than its growth in the previous quarter of 7.7% and higher than its 3-year average of 7.3%. This was driven by higher household consumption growth and exports. The real exports growth rate increased from 4% in Q1 to 13% in Q2 on the back of strong manufacturing sector growth. The high exports growth rate was the strongest in 4 years. In *Japan*, economic growth was unchanged, at 1.0% yoy, lower than its 3-year average of 1.3%. Higher private consumption growth was offset by a decline in government consumption, while the exports growth rate also slowed. Combined with a higher imports growth rate, this resulted in a negative net contribution of exports to growth. In *Korea*, the GDP growth rate was also unchanged at 2.8% yoy, slightly lower than its 3-year average of 2.9%. Export growth accelerated to 4.8% compared to 1.6% in the previous quarter, supported by robust manufacturing exports. Meanwhile, the import growth rate declined, resulting in a positive contribution of net exports to GDP growth for the first time in 3 years. Nonetheless, the higher contribution of net exports to growth was offset by a contraction in investment growth and a slowdown in household and government consumption growth. In *China*, the GDP growth rate slowed slightly from 6.8% to 6.7%, its slowest in 2 years. This was likely due to lower investment growth, reflecting the government's efforts to deleverage and tackle shadow banking. Exports growth also slowed while imports remained robust. Continued trade tensions with the US are expected to continue to weigh on exports. Overall, the relatively unfavourable growth performance in China, Japan, and, to some extent, Korea reflect the challenges they face from external sectors, which have also spilled over to countries in Southeast Asia well into Q3.

During Q3, the manufacturing PMI shows that economic activity in the East Asia region still expanded, but there are no signs of a substantial reversal from the economic growth deceleration in the previous quarter. As **Figure 4** shows, the manufacturing PMI indicates that the manufacturing sector still expanded in Q3 in most countries. However, the expansion rate was not particularly strong, especially when compared with the expansion rates in advanced economies. The manufacturing PMI average for Q3 was only at around 52 or lower in most countries, reflecting a marginal expansion. The Q3 expansion rate was broadly unchanged from Q2 expansion in Singapore, India, Indonesia, and Thailand, but there was a deceleration in Viet Nam, China, Japan, and the Philippines. The index has been on a declining trend in Viet Nam, from 55.7 in July to 51.5 in September, the lowest in the past 10 months. This was due to a slower increase in output, new orders, and employment in the manufacturing sector, reflecting weaker demand compared to Q2. It also fell to a 5-month low in the Philippines in July, continuing the slowing economic growth from Q2. This was similar for Japan and China, where the manufacturing PMI expansion rate has been on a declining trend since early 2018. In Japan, the manufacturing sector still shows expansion even though at a lower rate than in Q2. In China the PMI fell to 50 in September, the lowest since mid-2017, likely reflecting continued trade tension with the US. There was steady improvement in Malaysia and to some extent in Korea. In Malaysia, the manufacturing sector expanded for the first time in August after a continued slowdown from February 2018. This was a reflection of the end of the uncertainty surrounding the general election period in Q2. In Korea, PMI also shows expansion in September after a continuous contraction from March 2018. Stronger domestic demand has compensated for slowing exports growth in the past 2 months.

Exports growth did not show firm signs of picking up in Q3 despite the deceleration trend appearing to have bottomed out in the middle of Q2. As **Figure 5** shows, the exports growth rate decelerated significantly from early 2018, likely reaching its bottom in April 2018. Since then, however, there has been no sign of a firm pickup across all countries. The pickup was quite strong in India and Singapore but relatively muted in Japan, Korea, and, to some extent, China and other Southeast Asian countries. In fact, the growth rate slightly declined again or levelled off in most countries in early Q3. The pickup in India and Singapore was driven by stronger manufacturing exports. Meanwhile, the subdued exports growth rate in Japan, Korea, and, to some extent, China was caused by lower external demand.

The above overview shows that countries that are able to maintain their export momentum, such as India and Korea, are likely to overcome external uncertainties better. Hence, one major policy focus would be to strengthen the competitiveness of the traditional export-oriented manufacturing sector. In Q2, the manufacturing sector still grew in most countries in the region, albeit with a slight deceleration. With the exception of India and Korea, as shown in **Figure 6**, manufacturing value added growth slowed slightly, particularly in the Philippines, followed by Thailand and Indonesia. In India, manufacturing exports rebounded relatively strongly, supported by good performance from the automobile, textiles, and consumer durables sectors. Korea was supported by strong semiconductor exports. Overall, recent economic performance in the East Asian region has remained positive but has been overshadowed by the risk of deceleration due to weaker exports and manufacturing sector performance. Continued volatility and uncertainty in international financial conditions and trade have contributed to the trend and are likely to continue to do so in the near term.

Volatility and Uncertainty

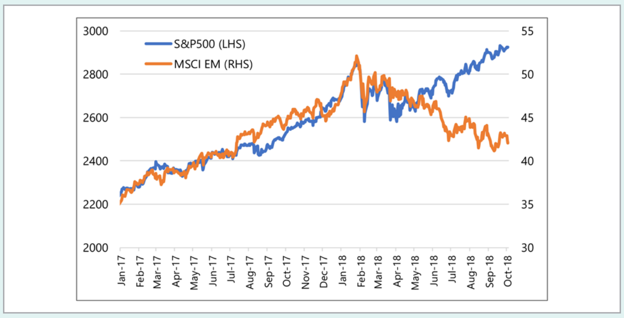
Financial volatility and trade uncertainty in Q2 have continued well into Q3. Capital outflows from emerging markets due to higher a US interest rate and a strengthening of the US dollar have continued. In addition, macroeconomic instability in Argentina and Turkey briefly led to market panic in other emerging market economies, including those in the East Asia region. As Argentina's peso and the Turkish lira have depreciated by around 50% and 40% year-to-date (as of 5 October), respectively, there is a concern of contagion in some East Asian countries and a potential repeat of the 1998 financial crisis. The uncertainty in international trade has also continued due to the ongoing trade war marked by the exchange of threats of tariff increases.

Capital outflows from emerging market economies to advanced economies have continued. This is reflected in the divergence between the stock markets in the US and emerging market countries, where markets rebounded in the former and fell in the latter. As **Figure 7** shows, this has been a trend since early Q2 but became more apparent in Q3. As of early October 2018, the S&P 500 in the US recorded a 9% return, while the MSCI Emerging Markets Index recorded a 13% loss in emerging market equities, a 22 percentage point divergence between the US and emerging market equity markets. Furthermore, the stock markets in the region continue to be volatile **(Figure 9)**, with diverging trends across countries within the region. India showed a rebounding trend until the end of August, before falling sharply, whereas China's stock market experienced a relatively sharp fall from early July. As **Figure 10** shows, as of early October, China's equity market recorded a 15% loss and the Philippines' recorded a 19% loss. The large fall in China was caused by a fear of a slowing economy and was aggravated by a fear of a further trade war escalation with the US. The recent big fall in the Philippines and India was caused by concerns over higher inflation, rising oil prices, a weakening currency, negative external sentiments, and several domestic issues. In addition to outflows in the equity market, there were also corrections in the bonds market. Bond yields increased considerably in most

Panel 2. Recent Financial Developments

The divergence between stock markets in the US and emerging market countries has become more pronounced. Markets rebounded in the former but fell in the latter.

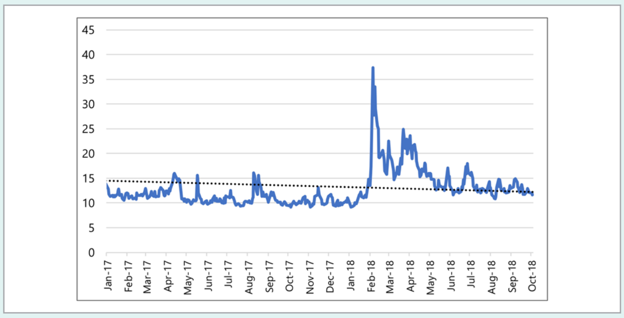
Figure 7. Global Stock Market Index



MSCI EM = Morgan Stanley Capital International Emerging Market; ytd = year-to-date; LHS = Left hand side; RHS = Right hand side.
Note: as of 6 June 2018.
Source: Bloomberg, Yahoo Finance.

The measure of volatility in the US stock market, the Chicago Board Options Exchange Volatility Index (VIX), continued to be stable in Q3.

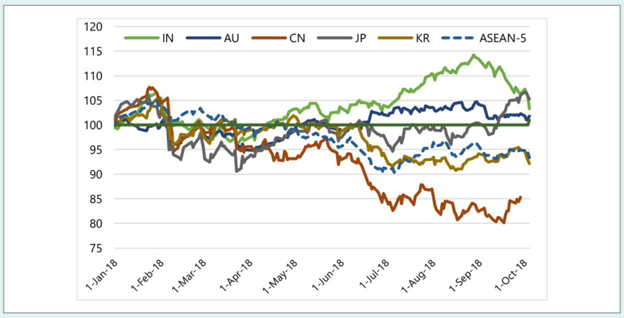
Figure 8. VIX Index



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

Stock markets in East Asia continued to be volatile, with an increasing diverging trend across countries from early June 2018.

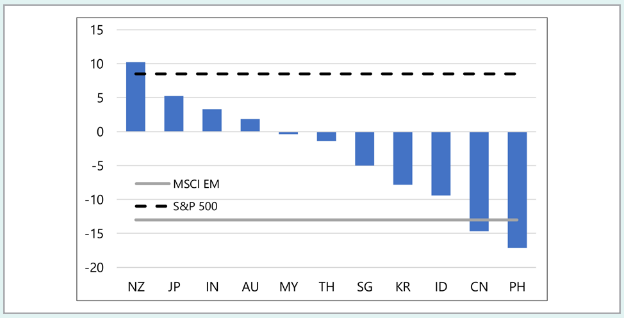
Figure 9. Stock Market Index in East Asia
(29 December 2017 = 100)



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

Most stock markets in the region recorded losses, including the emerging markets. China, Indonesia, and the Philippines recorded the biggest losses.

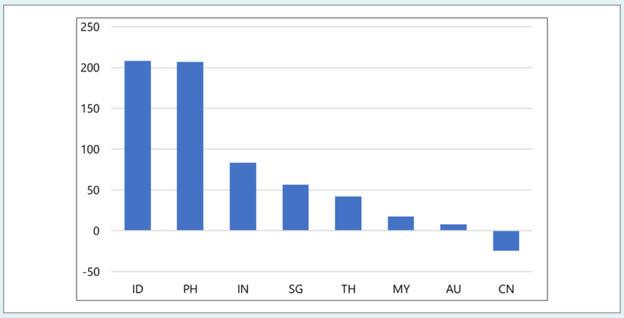
Figure 10. Stock Market Return in East Asia, 2018
(year-to-date %)



AU = Austalia, 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 4 October 2018.

Bond yields increased considerably in most countries, led by Indonesia and the Philippines, reflecting declining prices in government bonds due to capital outflow.

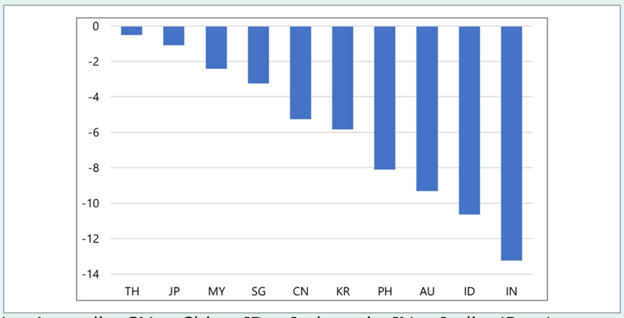
Figure 11. Change in Benchmark 10-year Bond Yield
(year-to-year basis points)



AU = Australia, CN = China, ID = Indonesia, IN = India, MY = Malaysia, PH = Philippines, SG = Singapore, TH = Thailand.
Note: Data are as of 4 October 2018.
Source: Bloomberg, Yahoo Finance.

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

Figure 12. Change in Foreign Exchange Rate per US$1
(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.
Note: Positive values denote currency appreciations. Data are as of 4 October 2018.
Source: Bloomberg.

countries (**Figure 11**), led by Indonesia and the Philippines with a 200-basis point (bps) increase, followed by India (80bps). This reflects declining prices in government bonds due to capital outflows. As a result of the capital outflows, most currencies in the region depreciated against the US dollar (**Figure 12**). As of early October, the largest depreciation was recorded in India (13%), followed by Indonesia (11%), Australia (9%), and the Philippines (8%). The large depreciations in both India and Indonesia were partly driven by concerns over widening current account deficits. In Q2 2018, India's current account deficit reached 2.4% of GDP, the highest in the past 4 quarters, while in Indonesia it reached 3.0%, the highest in 4 years. The strengthening of the US dollar is expected to continue as the Federal Reserve is on track to further raise interest rates this year and next year. Strong wage growth in August and September of 2.9% and a low unemployment rate have cemented the rise.

Similarly, uncertainty in international trade has continued. In late September, the US imposed tariffs on U$200 billion worth of imports from China, following tariffs on US$16 billion of imports imposed a month earlier. In the latest bout, the US has threatened to impose tariffs on all imports from China. After a long period of uncertainty over the North American Free Trade Agreement (NAFTA), in late September, the US, Canada, and Mexico agreed on a new trade deal replacing NAFTA. The so-called United States–Mexico–Canada Agreement (USMCA) incorporates changes to cars trade and new policies on labour, environmental standards, intellectual property protections, and some digital trade provisions. The deal will need quite some time to be signed and ratified before it is implemented. In the European Union, even though the US and the European Union declared a trade war truce in late July and promised to work together to reduce trade barriers, uncertainty still weighs heavily as President Trump, in late August, reiterated the threat to impose tariffs on European automobiles. This uncertainty has affected business confidece and investment decisions. However, the uncertainty has also brought the opportunity of closer trade relationships between member countries in the East Asia region, for instance between China and Japan, who realise the need for strengthened cooperation during such trade frictions. The trade uncertainty has also reminded companies of the importance of reducing their production risk by diversifying their manufacturing bases. Some companies in recent years have relocated production to Southeast Asian countries, for instance Viet Nam, to benefit from lower wages and shield themselves from the potential trade frictions between the US and China. The current uncertainty is an opportunity for other emerging economies in the East Asia region to promote and attract more direct investment into their manufacturing sectors.

The current financial volatility and trade uncertainty have affected countries in the region to varying degrees. Countries with relatively strong fundamentals have been able to withstand the challenges better. Countries with weaker fundamentals, however, such as those with current account deficits, for instance Indonesia, India, and the Philippines, have been more affected. Currency depreciation might further translate into higher inflation rates and problems with corporate and government external debt sustainability. Such problems would undermine economic growth and discourage new capital inflows, resulting in a negative feedback loop. Thus, the extent to which this volatility and uncertainty will affect countries' growth outlooks depends on their ability to preserve macroeconomic stability and continue to improve competitiveness. Nonetheless, foreign investors also need to differentiate carefully between emerging markets. The relatively vulnerable emerging markets in the East Asia region, particularly India, Indonesia, and the Philippines, have generally much better fundamentals (in terms of higher economic growth, a lower fiscal deficit, and a lower current account deficit) compared to other emerging markets, for instance Argentina, Turkey, South Africa, and Brazil. As such, there is a need for governments in the East Asia region to have better communication with international investors and continue conservative macroeconomic policies to restore confidence and halt market panic.

Countries in the region have managed the recent financial volatility relatively well by prioritising macroeconomic stability over growth. Some countries have allowed their exchange rates to adjust, increased interest rates, and pursued policies for reducing imports. This has helped to stabilise shocks and restore confidence as fears of a repeat of the 1998 financial crisis have increased in some countries. Indonesia has raised its policy rate by 150bps since mid-May, while India has raised its rate by 50bps since mid-June, and the Philippines has raised its rate by 150bps since mid-May. The latest increase of 50bps in the Philippines in August and September was the country's sharpest rate increase since 2008. The Indonesian government has also increased its import levies on some products and mandated the use of palm biofuels blending in some sectors to contain imports. However, the risks remain substantial. If the currency crisis in Argentina and Turkey results in a broader banking crisis, investors' risk aversion will increase, thus raising the risk of contagion effects to emerging markets in the East Asia region.

Finally, the effects of the recent episode of exchange rate fluctuations on trade depend on domestic policy responses. Higher exchange rate volatility could negatively affect trade through higher hedging costs for importers. The impacts could be exacerbated for production networks due to the sensitivity of intermediate goods prices to exchange rate volatility. [1] However, the extent to which the currency depreciation translates into an improvement in the trade balance depends on the readiness of countries' exports sectors to seize the opportunity. The improved competitiveness due to depreciation might not be fully utilised by countries with limited manufacturing bases due to the inelastic supply of manufacturing capacity. However, their service sectors such as the tourism sector could benefit as capacity bottleneck could be addressed within a shorter period of time. Overall, this calls for an improvement in supply-side factors, as argued in the previous EAU Q2 edition. This period of volatility and uncertainty should be used as a window of opportunity to make long-term efforts to improve competitiveness. Otherwise, countries in the region will always be negatively affected by volatility in cross-border capital flows, which is likely to occur more frequently in this era of increasing US interest rates. Emerging market economies that conduct reforms and are able to portray themselves as different from other emerging markets will have greater macroeconomic stability. In conclusion, Q3 in the East Asian region was marked by continued volatility and uncertainty. If not addressed appropriately through short-term and long-term measures, this could result in macroeconomic instability and further drops in business confidence and investment, causing the synchronised and long-awaited recovery of 2017 to be short-lived.

[1] Hayakawa, K. and F. Kimura (2008), *The Effect of Exchange Rate Volatility on International Trade in East Asia*. Jakarta: ERIA.

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