Challenging Times for Southeast Asian Economies*

By Manu Bhaskaran

Southeast Asia will be hurt badly by the financial crisis, precisely because its economies are so deeply tied to the global economy. But if the right policy adjustments are made, this part of Asia could well come out a winner in the post-crisis world, writes economist Manu Bhaskaran.

SOUTHEAST ASIA IS AMONG the most open economic regions in the world. Its linkages with the global economy extend beyond direct trade connections to include financial flows, tourism, remittances and commodities. Consequently, Southeast Asia is bound to be hurt materially by the global economic and financial crisis, with economic growth rates in 2009 likely to be substantially down for most countries. However, far from anticipating a regional downturn on a par with the Asian financial crisis of 1997-98, there is a fair chance that economic growth in the region will rebound fairly quickly in 2010 and thereafter benefit from the post-crisis global economy.

A GENERALIZED GLOBAL SLOWDOWN

The global environment is turning increasingly hostile. The most recent data point to a fairly precipitous deceleration in global economic activity. Chart 1 shows purchasing manager data for the global economy as a whole: note the sharp fall in October. Data for November suggest that this fall in activity has intensified. The region's most important manufactured export is various kinds of electronics components, where demand is already weakening quickly. As Chart 2 indicates, new orders in the key US market are falling, an ominous sign for the region.

The best available leading indicators are also trending negative, suggesting continued weakening of activity in 2009. Southeast Asia's economic growth is highly dependent on the United

*For reasons of data availability, my analytical focus in this article will be on Indonesia, Malaysia, the Philippines, Singapore and Thailand.

States, Europe and Japan. As Chart 3 shows, the leading indicators developed by the Organisation for Economic Co-operation and Development (OECD) are looking down, pointing to substantial economic weakness in all the region's major export markets in 2009.

SOUTHEAST ASIA CANNOT EASILY ESCAPE

Chart 4 depicts the region's high dependence on exports in comparison with China. Even Vietnam, a relative latecomer as a global manufacturer, has a fairly high export to GDP ratio approaching 70 percent. With trade financing disrupted as a result of the turmoil in global banking, letters of credit that are used to fund up to 40 percent of global trade are not being issued in the volumes needed: this disruption is partly the reason for the rapid fall in economic activity depicted below.

Graphic 1 (page 50) presents a schematic table outlining the various mechanisms through which the global crisis impacts regional economies. Clearly, the damage goes beyond just the trade channel — Southeast Asia is highly integrated into the global economy through multiple channels other than trade. In summary, note that:

- Singapore and Malaysia are probably the most vulnerable. Not only are they highly exposed to trade but their exports also tend to be concentrated in a few highly vulnerable segments such as electronics components. Global manufacturers

CHART 1 PERCIPITATE NATURE OF GLOBAL SLOWDOWN

JP Morgan Global Purchasing Manager Index

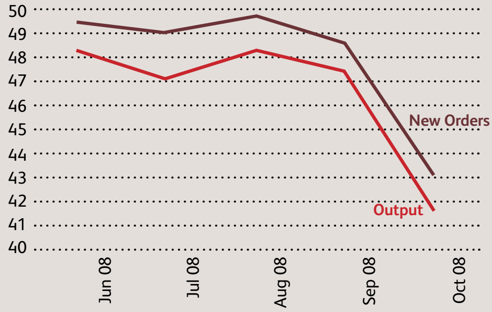


CHART 2 NEW ORDERS: BAD SIGN FOR ASIAN EXPORTS

US New Orders: Computer & Electronic Products

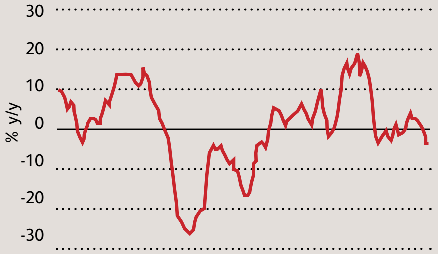


CHART 3 OECD LEAD INDICATORS: SHARP DOWNTURN IN G3

OECD CLI

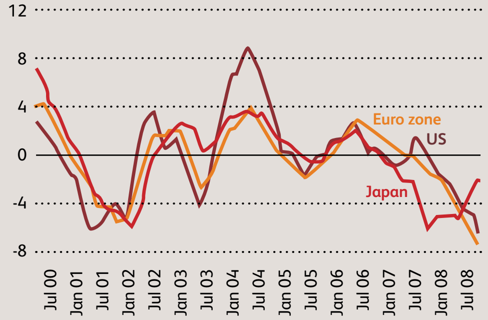
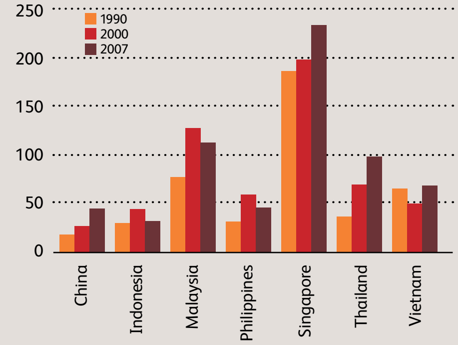


CHART 4 ASIANS' EXPOSURE TO EXPORTS IS HIGHER

SE Asia Exports / GDP Ratio %



Source: Charts 1 and 2 are collated by Centennial Group using media reports and CEIC Database. Charts 3 and 4 are collated using CEIC database have built large production networks spanning Singapore, Malaysia, Thailand and more recently Vietnam that are critical parts of the global manufacturing economy: when global demand stumbles, these manufacturing centers bear the brunt of production and employment cuts.

- If financial stresses are neglected or not well managed, an otherwise resilient economy could succumb. Most of the region remains relatively robust but Indonesia is of some concern. Indonesia's record of large devaluations and inflationary surges means that its consumers and businesses are quick to change their expectations for the currency and inflation. By precipitating capital outflows, such losses of confidence could cause destabilizing falls in the value of the currency.
- The region is also a major producer of commodities that are particularly sensitive to changes in the global economic cycle affecting demand and prices. Southeast Asia is the world's top producer of crude palm oil and rubber while also being a large exporter of base metals, oil, rice and other foods. After several years of record high prices for commodities boosted the incomes of rural households, we are likely to see a sharp fall in 2009.
- Southeast Asia is also a major tourist destination. Tourist flows are sensitive to the global economic cycle — as incomes and jobs become less secure, overseas travel is postponed and when people do travel they tend to stay within their home countries. However, countries such as Indonesia that have experienced large currency devaluations

GRAPHIC 1 MECHANISM OF TRANSMISSION AND ASSESSMENT

FINANCIAL

The region may suffer a further disproportionate outflow of portfolio capital due to political travails raising investors' risk aversion generally towards the region. Funding for new business initiatives will be increasingly difficult. Indonesia is particularly at risk.

FUNDING DIFFICULTIES

High savings rates limit the dependence of Asian companies in financing investments and acquisitions. However, Indonesia remains dependent on foreign inflows for funding such as budgetary support. Singapore has seen a number of very large investment projects in manufacturing and tourism being delayed as a result of funding problems.

DIRECT IMPACT

Singapore and Malaysia have extraordinarily high export/GDP ratios of more than 230 percent and 110 percent, respectively Thailand is also highly exposed, with Indonesia and the Philippines much less so.

Both consumer demand and business spending in developed economies is set to decelerate further. There is clear evidence that new orders for computers and related equipment in the United States will suffer a sharper slowdown than we have already seen.

RISK FROM CAPITAL OUTFLOWS

Most regional economies have relatively low ratios of financially mobile capital (foreign-owned stocks/bonds as well as foreign debt that is due for repayment in the short term) to foreign exchange reserves. This enhances the region's resilience to rising risk aversion directed at emerging markets. However, Indonesia still has substantial foreign ownership of its securities, making it vulnerable.

INDIRECT IMPACT

Wage income from the trade sector supports general consumer spending; this will slow.

Trade-related sectors — transportation, logistics and other trade-related services — will also take a hit. Regional transport hubs such as Singapore, Bangkok and Kuala Lumpur will suffer.

A gloomier global economy will cause domestic businesses to slow investment until there is more clarity on economic prospects and this will accentuate the slowdown in the shorter term.

ASSET MARKET RISKS

The risks of a real estate market crash aggravating the downturn are less in Southeast Asia where there are relatively few asset price bubbles compared to the United States or China.

have become cheap enough to increase market share and so remain relatively resilient.

SLOWER GROWTH AND HOST OF OTHER PROBLEMS

Clearly, the region cannot avoid a sizeable fall in economic growth rates in 2009. The various transmission mechanisms above also suggest that the region could have to deal with a number of other challenges:

- **First**, capital and real estate markets will remain under pressure as capital outflows persist. In other words, asset prices that have already plunged and reduced the wealth of ordinary families, will probably not recover quickly. Indeed, the correction in housing prices has probably only just begun in the region. Prices of residential homes in major urban centers — Singapore, Kuala Lumpur, Bangkok, Jakarta, Manila — all saw heady rises in recent years, putting them at risk of a sharp correction in a changed environment of tighter liquidity and higher interest rates.
- **Second**, slower growth will produce a welcome fall in inflation. However, there is a risk that the financial turmoil will be so damaging as to cause global deflation — falling prices akin to that suffered by Japan in the 1990s. Take Singapore for instance: It is entering this recession with a high cost structure after an economic boom since 2004 caused wages, rentals and other costs to rise sharply. With a sharp global slowdown unfolding, it is likely that businesses in Singapore will have

FOREIGN DIRECT INVESTMENT

Declining profitability among major investing companies, heightened risk aversion due to the global slowdown and funding difficulties will slow FDI into the region.

OIL PRICES

Falling oil prices:

Hurt Malaysia, a substantial producer — 44 percent of government revenues are oil-related.

Indonesia is less hurt as it is barely a net exporter of oil due to the fall in oil production in recent years and since the burden of fuel subsidies on its budget will decline.

Are a major boon for Thailand, reducing costs in fishing, manufacturing and transportation.

TRADE

World trade is forecast to stagnate in 2009.

Negative, with countries with the highest dependence on exports — Singapore and Malaysia — to suffer most.

OTHER COMMODITIES

Prices of economically sensitive commodities such as rubber and base metals will fall, hurting smallholders in Thailand, Indonesia and Malaysia as well as mining companies in Indonesia and the Philippines.

Food crops: increased supply will depress prices of rice, tapioca and crude palm oil — this is damaging to Thailand, Malaysia and Indonesia.

REMITTANCES

The Philippines is more exposed to remittance incomes from abroad compared to other Asian economies, as is Vietnam to a lesser extent.

TOURISM

The initial impact is for tourism to fall — hurting Hong Kong, Thailand, Malaysia and Singapore, in particular.

The impact will be mitigated by weaker Asian currencies (Indonesia will benefit) and lower transportation costs due to falling costs of air travel.

COMMODITY PRICES

Risky for Malaysia, positive for Thailand, neutral for Indonesia.

to restructure in various ways that could be deflationary: for example by downsizing workforces and pressing suppliers and sub-contractors to cut costs. There could well be a fall in consumer prices by the end of 2009 in Singapore as such restructuring gets underway.

- **Third**, the poorest segments of the population in the region might bear the brunt of the slowdown. Falls in commodity prices will hurt smallholders who produce the commodities and the rural labor they hire. Retrenchments and lower demand for labor in urban areas could hurt lower-skilled and older workers more. Income disparities may well widen as a result.

REGIONAL RESILIENCE

It is clear that the region will have to endure a period of pain in 2009. Nevertheless, the region has become more resilient to external shocks since the last crisis. The regional economies now possess better shock absorbers and fewer shock amplifiers compared to the 1990s. In combination with the adjustment mechanisms that will kick in, we believe that the region will be able to mitigate the downturn in 2009 and prepare itself for a recovery in 2010.

What are these adjustment mechanisms? The most important are policy responses. Regional policy makers are likely to respond aggressively with all the policy tools at their disposal:

- **Monetary policy:** With inflation now falling noticeably across the region, central banks will be more confident in easing monetary policy in coming months — interest rates will be cut, reserve requirements loosened and administrative restrictions on bank lending could also be lifted. Central banks will intervene in domestic money markets to ensure a plentiful supply of liquidity.
- **Fiscal policy:** Policy makers will almost certainly step up spending in order to offset the decline in external demand. Malaysia has already announced a large fiscal stimulus, for instance, with virtually every other country also coming up with new fiscal proposals. The key will be speed of implementation. Thailand, for instance, may have a problem because political turmoil is making it harder to implement fiscal spending plans.
- **Administrative policies:** This slowdown is not an ordinary cyclical adjustment where the conventional tools of monetary and fiscal policy could suffice. Because of the disruption to the critical process of financial intermediation without which real economic activity would be undermined, governments also need to act decisively to ensure that bank lending does not dry up. Singapore, for example, has announced measures to encourage banks to keep lending to riskier small- and medium-sized enterprises. Policy makers may need to use state guarantees to get trade financing moving again.

In addition to active policy measures, the regional economies also have their own more spontaneous adjustment mechanisms. For instance, exchange rates are now more market-driven and will adjust to the gloomier economic environment. Since the global financial crisis became serious, Southeast Asian currencies have benefited from the sharp appreciation of the Chinese RMB in real, trade-weighted terms — while their currencies have only appreciated by a small amount.

Another adjustment mechanism is the ability of exporters to switch away from products and markets that do well in boom times to other areas. Thai exporters have typically been adept, for instance, at such switching: they have increased exports to the Middle East and reduced their dependence on the OECD economies in recent years.

Moreover, Southeast Asia today is structurally more resilient. Exports have become more diversified and manufacturing is less driven by dependence on a narrow range of products. Singapore is an example — electronics used to generate, directly and indirectly, about 17 percent of GDP in

The global environment that Southeast Asia operates in is turning increasingly hostile. The most recent data point to a fairly precipitous deceleration in global economic activity.

the mid-1990s, but that figure has roughly halved as new sectors such as pharmaceuticals, marine engineering and wealth management have taken off. Similarly, Thailand has reduced its dependence on electronics by successfully expanding its automobile and related sectors. Malaysia has become one of the world's most competitive places for business process outsourcing.

WHAT CAN GO WRONG?

Despite the resilience described above, the scale and speed of the global slowdown creates a risky environment. This means that some regional weaknesses that could be managed or absorbed relatively easily in normal times become more dangerous in times like these. These risk factors include:

- **Political shocks:** Political disruptions are the kind of self-inflicted wounds that the region needs to avoid. Currently, the most worrying place is Thailand — protestors there have shown their willingness to deliberately undermine the economy through their occupation of Bangkok's two airports as well as their disruption of government affairs by taking over the seat of government. The prolonged political crisis is reaching a point where foreign investors are questioning whether they should remain committed to the country.
- **Financial and exchange rate vulnerabilities:** While resilient domestic demand has kept Indonesia's economy relatively robust, the concern is that the rupiah, which has been weakening for some time, could continue to fall, and reach a point where a loss of confidence leads to large-scale capital flight that could destabilize the economy.
- **Avian flu:** The H5N1 virus continues to affect birds and humans in the region. If the virus spreads more widely during the current climate of low business and consumer confidence, the effects on the regional economies could be severe.

BEYOND THE CRISIS: SOUTHEAST ASIA IN A GOOD POSITION

Given the trajectory of the global economy, it is likely that the early months of 2009 will be dismal, and many observers might become overly pessimistic. But this crisis, while serious, will pass as others have. In the post-crisis world, Southeast Asia should be in a position to take advantage of a number of positive developments and trends.

- After years of rapid growth and transformation, China is undergoing a shift to higher-value production. Rising costs and a stronger currency have reduced its edge in production. This opens the way for many countries in Southeast Asia — Indonesia, Vietnam and Cambodia — to benefit.
- The crisis will not undermine the long term growth potential of emerging market countries such as China, India, Brazil, Turkey, Vietnam and South Africa. So long as these large, populous countries grow, the demand for commodities that Southeast Asia is strongly competitive in — rice, rubber, crude palm oil, tapioca, cocoa, coffee, spices, basic metals — will grow relative to the available supply. Southeast Asia will benefit from this commodity demand. In addition, rising incomes in China and India will probably unleash a surge of tourism that Southeast Asia is well-positioned to benefit from.

Second, this crisis has taught policy makers in Southeast Asia and elsewhere a valuable lesson

Singapore and Malaysia are probably the most vulnerable. Not only are they highly exposed to trade but their exports also tend to be concentrated in a few highly vulnerable segments.

CHART 5 RISING RETURNS ON CAPITAL EMPLOYED IN ASIA

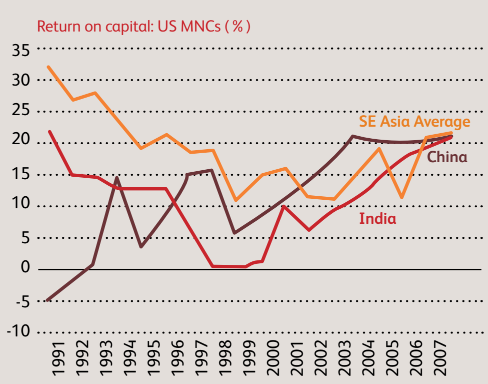
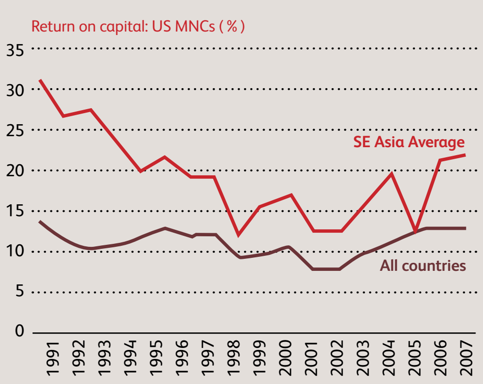


CHART 6 SE ASIA HAS AN EDGE IN GENERATING RETURNS



Source: Collated using data from the United States Dept of Commerce, Bureau of Economic Analysis

— the importance of diversifying demand so that there is less dependence on exports or on a restricted range of markets or products. Policy makers will be making more determined efforts in several areas to further the goal of a more diversified economy:

- A substantial rise in infrastructure spending that will boost demand in the short term and help sustain growth in 2009-2010. In the longer term, such infrastructure programs can help raise investment rates in the region and so restore economic growth to the high levels of the 1990s.
- More strenuous efforts to build social safety nets so that a downturn like the current one does not create so much pain for the least well off in society. There is likely to be more progress in areas such as retirement funding, supporting unemployed persons and reducing the burden of rising healthcare costs. In addition to improving the welfare of the most vulnerable segments of the population, such social safety nets also have the advantage of acting as automatic stabilizers during periods of economic difficulty.
- Efforts to develop home-grown financial institutions, especially savings institutions, so that regional bond and equity markets do not depend so heavily on foreign inflows. In this global crisis, for example, major problems in the developed economies were transmitted swiftly to Southeast Asia when fund managers were forced to liquidate emerging market holdings in response to stresses in their domestic markets. Developing indigenously owned financial institutions will help improve the resilience of domestic capital markets.

Ultimately, the region's economic prospects will depend on how competitive it is. As Chart 5 shows, Southeast Asia has over time generated returns on capital that match or are superior to those that China and India can provide. Chart 6 shows that Southeast Asia has out-performed the world steadily in terms of return on capital employed.

Despite this, Southeast Asia has lost out in terms of attracting investments in recent years. This is because the region has become riskier in some senses for foreign investors. There are two areas which need to be addressed:

- First, political risks have to be better managed. Thailand is not the only Southeast Asian country to suffer a political crisis. There is also considerable uncertainty in Malaysia over how its dominant political player, a coalition of race-based political parties, can rid itself of the distorted incentives that have promoted cronyism, corruption and degradation of key institutions. While Indonesia is emerging more successfully as a stable democracy than pessimists expected, corruption and cronyism remain major obstacles to a higher rate of economic growth. The Philippines, too, remains a worry for investors given continued instability, insurgencies and legal uncertainties for investors.
- Second, regional governments need to work much harder to improve the ease and cost of operating businesses. If they do so, Southeast Asia could well regain its position as one of the world's most popular destinations for foreign direct investment.

Finally:

- Southeast Asia is bound to be hurt by the global crisis given its substantial linkages to the global economy.
- Despite this, there is reason to expect some degree of resilience because of the shock absorbers the region now possesses.
- Once the crisis is over, the region could benefit from positive trends in the global economy if necessary policy adjustments to improve the business environment are made. The region is poised to be a winner in the post-crisis global economy.

Manu Bhaskaran is Partner/Head, Economic Research, Centennial Group in Singapore.