Asia: 3 questions

DBS Group Research
16 October 2012

- **Where (oh where) is global growth going to come from in 2013? From Asia, just like for the past 4 years**
- **Germany needs to expand domestic demand fast if the euro is to be saved. But it can't grow fast enough**
- **By contrast, Asia 'adds' an entire Germany to the region's economy every 3.5 years. If the euro is to be saved, Asia will be the one to save it, not Germany**
- **Why is China running at 7.5% and why will it accelerate to 8.5% in 2013? It's not about Europe; it's about investment**
- **What do QE3 and OMT mean for Asia? Not much, fortunately or unfortunately**

There's a lot of angst and uncertainty out there right now. The IMF just lowered its forecasts for global growth, the US faces a fiscal cliff come January and most of Europe is in recession already – even if the ECB did give the euro a little extra breathing room with its OMT [1] program a month ago. And speaking of OMT and (the Fed's) QE3 – emerging markets aren't exactly tickled pink about these programs. The fear is all that money will come washing over to Asia (like in 2010) and push currencies north and already weak exports further south. Nothing but nothing looks good right now and even solutions are problems if you're on the wrong side of the world!

From Asia's side of the world we ask 3 questions:

1) Where is global growth going to come from in 2013?
2) Why is China running at a 7.5% rate of growth and why is it likely to rise to 8.5% in 2013?; and
3) What do OMT and QE3 really mean for Asia?

Nomenclature

References to Asia in this report adhere to the follow conventions:

Asia 10: CH, HK, TW, KR, SG, MY, ID, TH, PH, IN

Asia 9: Asia 10 less IN

Asia 8: Asia 10 less IN and CH

Eurozone: EA17

G4: Asia10, US, JP, EZ

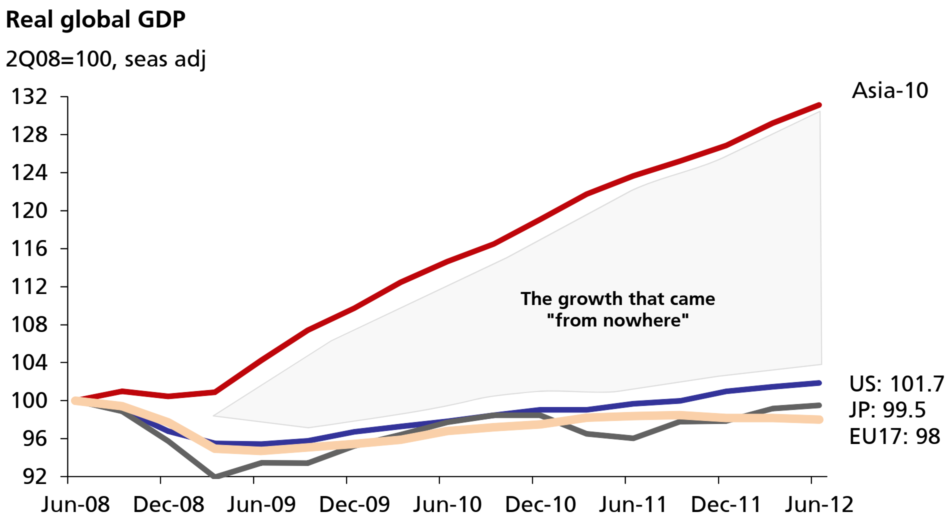
G3: US, JP, EZ

Where (oh where) is global growth going to come from in 2013?

First things first: the US has run at a sub-2% rate for the past six quarters and a fiscal cliff looms in January that could turn 2% growth into -2% growth. Europe's periphery has been in recession for several years and it's spreading to the core. Italy has contracted a 3% (saar) rate for the past 3 quarters, France hasn't grown a franc in 6 quarters and Germany's growth has fallen to 1% from 3% a year ago. Where oh where is global growth going to come from in 2013?

From Asia, just like it has for the past four years (chart at top of next page). If you think Europe's in trouble and the US is too and there's no hope for Asia then it's a good time to review just what Asia has managed on the growth front over the past 4 years – 4 years during which Europe and the US didn't do any better than they are today.

David Carbon • (65) 6878 9548 • davidcarbon@dbs.com



Since 2Q08, just before the collapse of Lehman Brothers, the G3 – the US, Europe and Japan – have run sideways at best. The US finally made it back to square one in 4Q11. Europe hasn't even done that. Output has fallen over the past four years and today it is 2% *less* than it was four years ago. Japan has fared better but not much. Together, the G3 are not yet back to ground zero.

What's Asia done over the past four years? What everyone said it could never do without the final demand of the G3 to drive it – it grew. And grew, and grew. Today (2Q12), output is nearly 32% higher than it was back in 2Q08.

Who's going to drive growth in 2013? Asia. Just like for the past 4 years

Eight percent growth per year for four years – a compound rate of nearly 7.5% per year. That's almost as fast as Asia grows in normal times. But it did it right through the biggest financial / economic crisis in 100 years. And without the help of Europe and without the help of Japan and without the help of the US. 32% growth in Asia; 0% growth in the G3.

So the next time you wonder where the growth is going to come from, pull out the chart above and have a good loooong look at it. Better yet, leave a copy on your desktop as a daily reminder. Who's going to drive global growth in 2013? Asia, just like last year. And the year before. And the year before that.

Is Asia decoupling from the world? Not at all. The world is more interconnected than ever before. But Asia is driving the growth that used to be driven by other economies. In terms of the picture above, if Asia hadn't run northward like it did, the G3 would have run south, instead of merely treading water.

Q2: Why is China growing at 7.5% and why will it pick up to 8.5% in 2013?

Okay, you say: Asia may drive growth in 2013 but even Asia is running a little slow today. China is growing at a 7.5% pace instead of the 9.5% pace it used to run at. Asia is running at 6%-6.5% instead of 7%. What's that all about?

Let's first talk about what it's not about, or not mainly about. China's (and Asia's) slower pace of growth are not mainly about Europe. Another look at the picture above should make that pretty clear. Europe has been falling for 4 years – all the while Asia grew by 32%. If Europe was Asia's problem, Asia would have felt it long ago.

A new Germany every 3.5 years

Another way to get a feel for this is to consider the following. In the last four years, when Asia grew by 32%, it "added" an entire Germany to the Asian economy, right here inside Asia's borders. If Germany – the country that purportedly will have to 'save' Europe if it is indeed to be saved – had fallen off the map four years ago, Asia would have replaced it by early this year. Not just the exports that would gone to Germany – Asia would have 'replaced' the whole economy.

Extend that thought out a few years. In 2011, Asia-10 GDP was $12.9trn. If you grow that by 7.5%, you generate some $967bn of growth. Germany's GDP was $3370bn in 2011, or about 3.5 times larger than Asia's growth. In other words, every 3.5 years, Asia "adds" a Germany to its economy. Throw Germany out the window today, Asia will replace it by 2016. And it will add another by 2020.

Asia 'adds' a Germany to the region's economy every 3.5 years

That's how big Asia is today and how fast it is growing. A weak Europe will never be a plus for Asia. But it has never mattered less either.

Flip Asia and the Eurozone around

Consider the reverse – i.e., not what the Eurozone means for Asia but what Asia means for the Eurozone. At its most basic level, most view the EU debt crisis as a problem of competitiveness differentials between the periphery (Spain, Ireland, Portugal, Greece) and the core (Germany, France, Italy). Balance of payment problems have brought a large build up of debt in the former, owed to the latter, mainly to Germany. The only way to pay back the debt is for the periphery to start running surpluses and / or for Germany to start buying a lot more output from the periphery.

Hence the IMF and virtually all the G20 nations urge Germany to ramp up its domestic demand growth. Germany has so far been reluctant to do so for fear of higher inflation. But suppose Germany did agree to raise its GDP growth rate – say to 5% per year from the 1% rate averaged over the past year. And suppose Germany said it would maintain that for the next 4 years. Would that make the EU happy? You bet. Five percent GDP growth would make Germany the toast of the town.

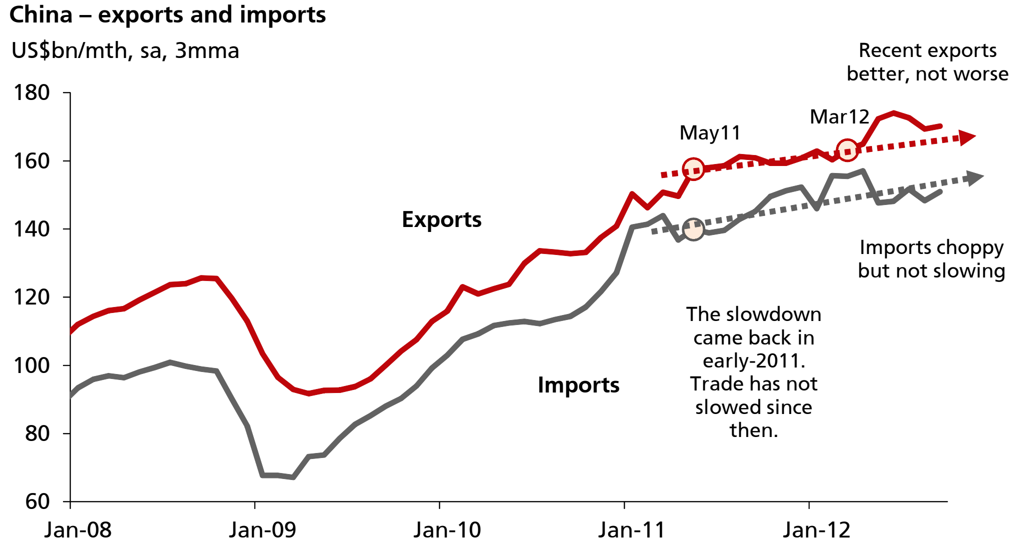
Now, suppose Germany got so much praise that it agreed to double that to a 10% growth rate for the next 4 years. Never mind how, just assume that where there's a will, there's a way. Wow, the periphery would be ecstatic.

So Germany decides to pull out all the stops – it decides to ramp that growth rate all the way up to 19% per year. Merkel announces Germany will double the size of its GDP in 4 years. The Eurozone rejoices – problem solved. Germany is the savior; Merkel is Queen.

Germany can't create a new Germany every 3.5 years. Asia can, and does

Now of course Germany can't double the size of its economy in 4 years. No country can. But Asia can, in effect, do just that – Asia puts a new Germany on the map every 3.5 years.

This puts a whole new spin on the Eurozone debt crisis. In the short-run, Germany is still going to have to fork over a lot of euros to ringfence a lot of bad assets and keep markets from putting an end to the euro. But in the long-run, where only growth and new demand will solve the problem, Germany can't grow fast enough. Germany can't create a new Germany every 3.5 years. But Asia can. And does. If the euro is to be saved, Asia is probably going to be what saves it.

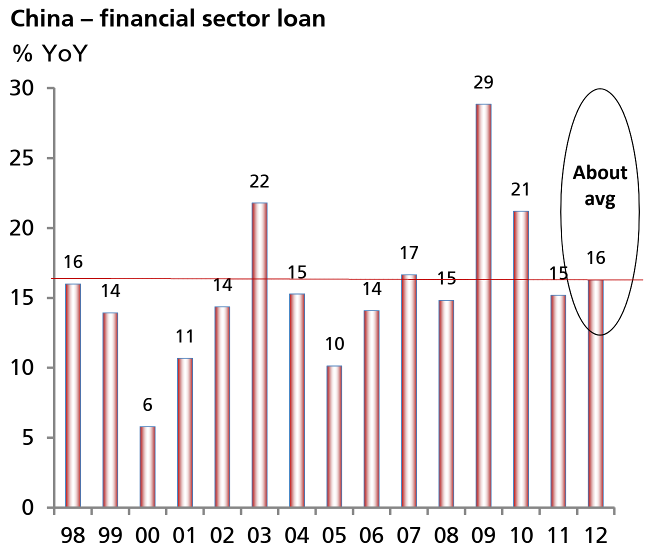


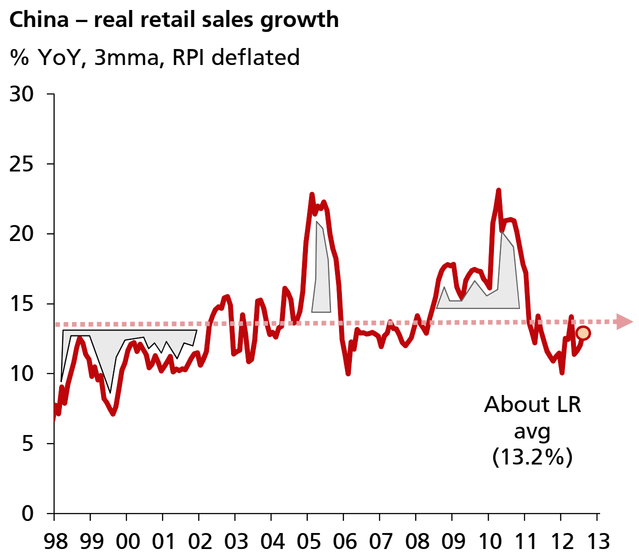
China proper

Let's get back to China proper. What else is not behind the slower (7.5%) GDP growth there?

It's not exports to Europe and it's not exports more generally either. The slowdown in trade, whether respecting China or Asia overall, came way back in early-2011 (chart above). Both exports and imports have run fairly steadily since then. Exports, moreover, have looked better in recent months, not worse, in sharp contrast to what most analysis and media reports have suggested.

If it's not about exports, it's not about loan growth either. Current growth is running at 16%, just about the long-run average (chart below left). Nor is it about weak consumption. Retail sales growth is a couple of points slower than usual but inflation – now at 1.9% YoY – is slower than normal too. In real (inflation-adjusted) terms, retail sales growth is running every bit as fast as it usually does (chart below right).





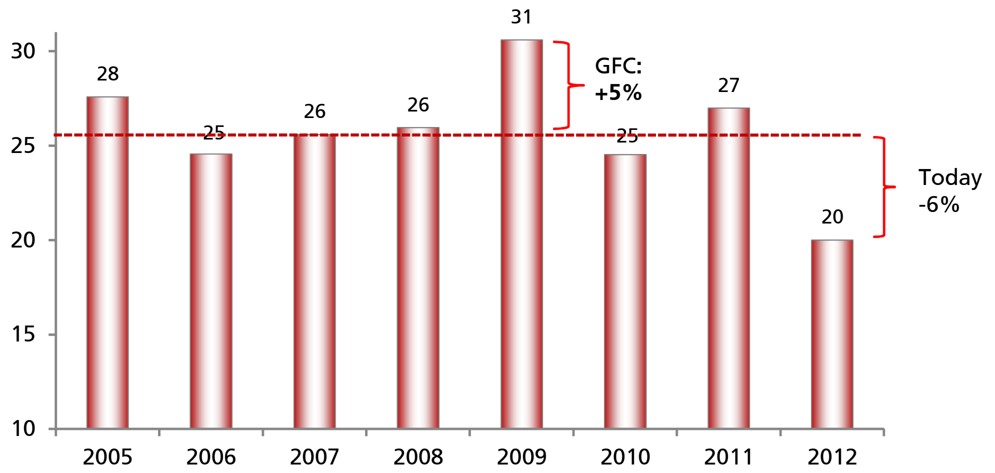
Investment is the 'culprit'

The reason why China's GDP growth is running at 7.5% instead of 9.5% is investment – growth has slowed considerably in 2012 and, for the record, most of that has been intentional.

Since 2005, fixed asset investment (FAI) growth has averaged 26% per year (chart below). In 2009, it ran 5 percentage points above average to counter the global financial crisis. Today, it is running 6 percentage points (30%) below average.

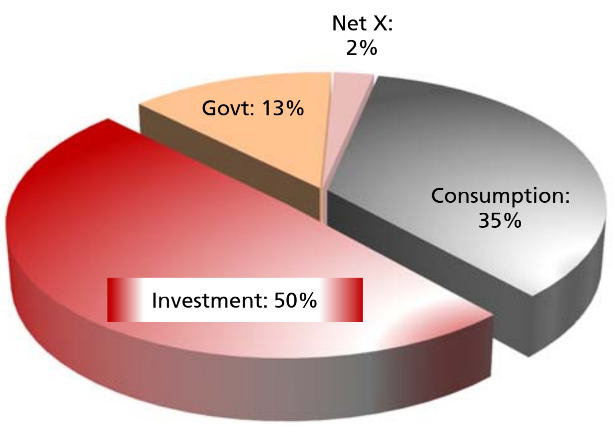
China – fixed asset investment

% YoY



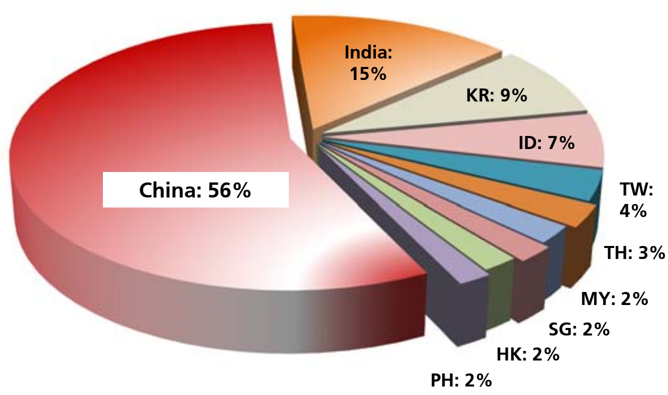
Does that 30% drop in investment growth make a difference? Yes it does. Investment accounts for 50% of China's GDP and China accounts for 56% of Asia10 GDP. Investment growth in China makes a big difference to China's and Asia's GDP growth.

China – GDP shares, 2011



Asia10 – GDP shares, 2011

Total pie: US$13,000bn

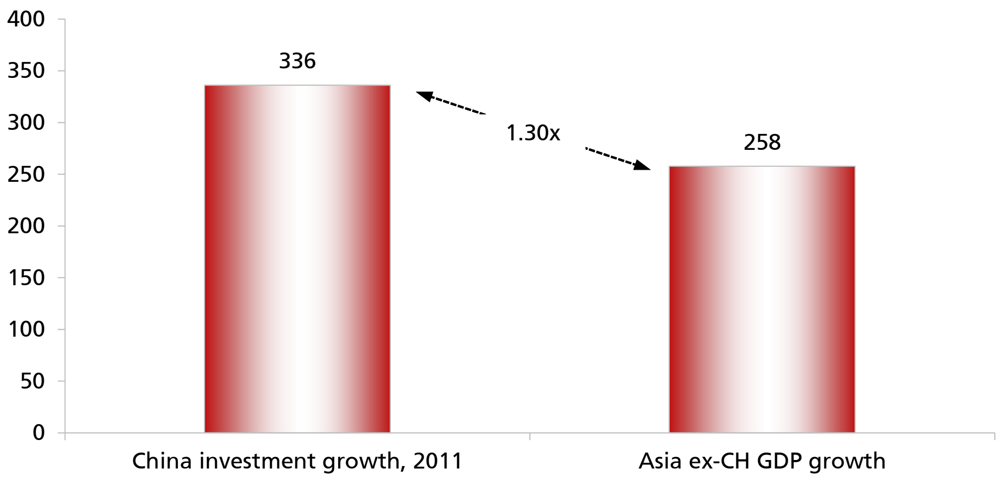


How much of a difference? That's easy to calculate. China's (total) investment grew by US$336bn (in 2010 prices) in 2011. That's 28% more than all the GDP growth in all the other Asia10 countries combined! In fact, China's investment alone grew by more than the entire US economy grew by in 2011. In short, it's a big number.

China's investment alone grew by more than the entire US economy grew by in 2011

China investment growth and Asia (ex-China) GDP growth

absolute dollar growth, constant 2010 US dollars (bn)

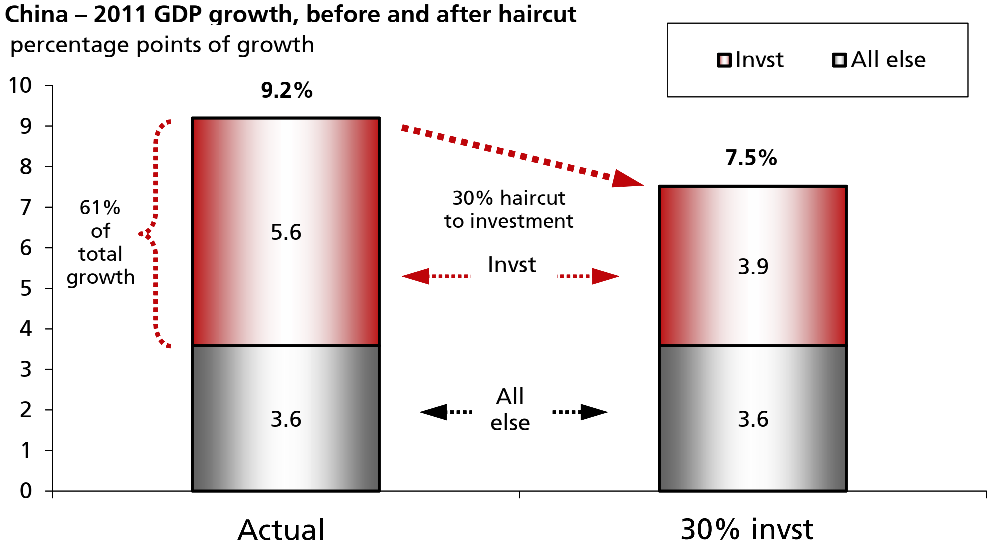


If you lop 30% off of that $336bn of investment growth, China's GDP growth would have fallen from the actual 9.2% registered in 2011 to 7.5% – right where it is today. Asia-10 GDP growth would drop to about 6.5%, right where it is today too. The bottom line is that while Europe isn't helping growth in Asia, the drop in China's investment growth accounts for 100% of the slowdown there and in Asia more generally.

Lop 30% off of China's investment growth in 2011 and GDP growth would drop to 7.5% – right where it is today

China – 2011 GDP growth, before and after haircut

percentage points of growth



What gives?

All of which begs the questions, why is investment slow? It's slow partly because the authorities want it to be and partly because they have been distracted by other things. On the former, there was a good deal of forced investment following the global financial crisis of 2008/09, some of which was not as efficient/productive as it might have been. The authorities are rightly in no hurry to force feed more projects on an economy already suffering from a case of indigestion. This is particularly so in the property sector, which accounts for the lion's share of the drop in FAI growth between August 2011 and August 1012 (table below).

Once the leadership transition is out of the way, watch for an investment rebound. That should take GDP growth back to 8.5% in 2013

There is also conscious effort underway to steer a structural shift towards a more consumption-led growth path. For this reason too, authorities are in no hurry to ratchet up investment. Recent decisions not to lower interest rates and, indeed, to allow the yuan to begin appreciating again against the US dollar underscore how sanguine officials are about the pace of growth today.

But officials have had a lot of other things to think about lately and these 'distractions' have surely played a role in keeping kept investment growth slower than normal too. The once-in-a-decade leadership transition has temporarily taken attention away from short-term cyclical economic issues, as have high-profile criminal trials and emotionally charged squabbles over rights to disputed island territories.

Our sense is that once these 'distractions' are out of the way, officials will kick investment back up a notch or two. Not because they have to but because they can. China's growth rate, like all countries', must slow as incomes rise. But potential growth doesn't drop to 7.5% from 10% over the course of a year – it does so over the course of a decade. There are massive opportunities to develop inland areas and there seems little reason why investment cannot continue to grow rapidly and efficiently in the years ahead. China's income levels are still but one-tenth those of Singapore and if the latter can grow at 5% sustainably (Spore's growth has averaged 6.3% over the past decade) then 8.5%-9% seems eminently doable for China.

While we do not expect FAI growth to head back to 26%-27% it has averaged since 2005, a return to the half way mark – 23%-24% – seems likely. That would put GDP growth back at 8.5% in China in 2013 and much closer to 7% for the Asia-10 overall.

China – Fixed asset investment slowdown
key contributors

	Growth rate Avg 09-11 (1) %	Growth rate Aug-12 (2) % ytd	Chg in growth rate (1)-(2) % pts	FAI growth Aug10-Aug11 (4) RMB mn	FAI growth Aug11-Aug12 (5) RMB mn	Chg in FAI growth (4)-(5) RMB mn	Contrib to total drop (7) %	Share in total FAI Aug12 ytd %
FAI Total	29	21	-8	3,960,987	3,735,046	-225,942		100
Primary	50	31	-19	174,052	131,530	-42,521		3
Secondary Total	28	23	-4	1,996,000	1,833,191	-162,810		45
Mnfg total	31	24	-7	1,822,934	1,491,973	-330,960		35
Textiles	34	14	-20	93,911	31,519	-62,392	28	1.2
Non Met Min prods	39	18	-21	180,597	115,265	-65,333	29	3.5
Univ Equipment	36	13	-23	143,787	60,581	-83,206	37	2.5
Elec Mach and Instr	54	8	-45	206,073	40,762	-165,311	73	2.4
Telcom & computer	32	13	-19	106,878	41,392	-65,486	29	1.7
Teriary (Total)	29	18	-11	1,790,935	1,770,325	-20,610		53
Real Estate	30	21	-9	1,200,054	961,759	-238,295	105	26
Water Conservancy	39	16	-23	42,996	30,138	-12,858		1

Q3: what do QE3 and OMT mean for Asia?

Trouble in Europe and the US has led to QE3 and OMT – open-ended central bank programs of bond purchases / monetary expansion. The last time this happened, Asia saw a lot of capital inflow. Between Jan 2010 and August 2011, foreign reserves rose by nearly $2 trillion (chart below), equity markets soared by 21%, currencies appreciated by 8.1%. Asia-10 inflation rose to 5.2% YoY and central banks delivered 50 interest rates trying to cool things down. Is Asia-vu coming all over again?

If Fed 'injections' don't go into the economy, they can't come rushing over to Asia a day later...

... don't look for a big impact on Asia from QE3

Probably not. The QE model that most people have in their heads – that central banks pump money into the economy and it then rushes over to Asia, say, where growth and returns are higher – is wrong. In fact, most (80% or more) of the money the Fed has 'injected' into the economy has stayed right there at the Fed in the form of excess reserves. Banks have been unwilling to put the money to work in the economy, which is why QE1 and QE2 haven't had much impact and why the Fed has had to resort to QE3. The same is true of ECB 'injections'. In fact, the ECB has intentionally 'sterilized' its injections, withdrawing as much from the system as it injected via bond purchases. In both cases, if the money doesn't go into the economy, it can't come rushing over to Asia the next day.

So where did all the inflow into Asia come from back in 2010 and 1H11? It came from investors taking comfort in the Fed policies and putting 'more risk on the table'. Other things equal, one might expect that again now, with QE3 and OMT.

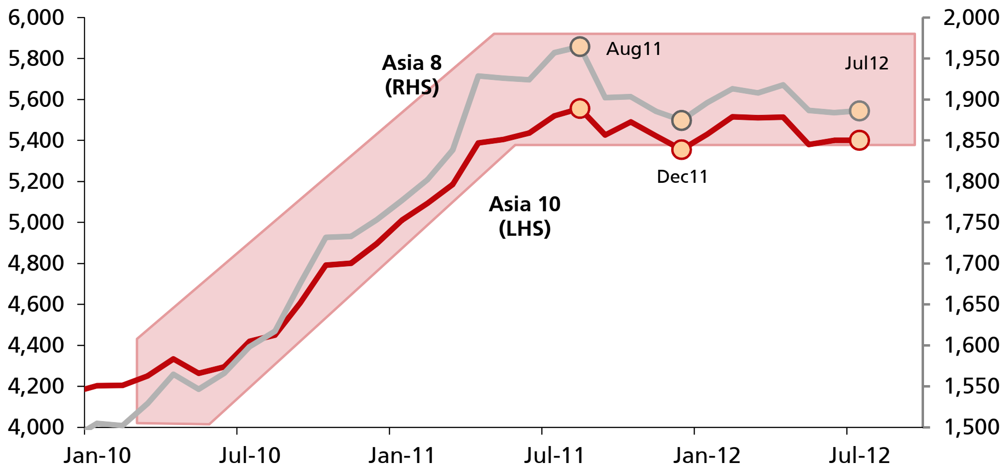
But other things aren't equal. The reason inflows dried up in August 2011 is that investors began to fear a euro break-up and took risk off the table. Unless QE3 or OMT removes that risk, inflows are unlikely to return in a big way.

Plainly, QE3 does not lower the risk of a euro break-up, or only very indirectly. But neither does the OMT, except in the short-run. The ECB/OMT promises to buy bonds (if countries sign up for reforms) and that has pushed yields back down. But the OMT doesn't solve the underlying problems of the Eurozone, which are competitiveness differentials between the core and the periphery. The OMT has bought time for reform and restructuring; whether governments take advantage of it remains to be seen. So far, they have not, which means the longer-term risks of a euro break-up remain unchanged. Unless this changes, investors seem unlikely to greatly increase the amount of risk they put on the table.

While we expect some increase in capital inflow owing to a reduction in short-term euro risks related mainly to the promise of OMT, a return to the capital inflow days of 2010 and 1H11 in Asia seems remote.

Asia – foreign reserves

US$bn, effective = actual + fwd mkt commitments, both axis



Endnotes

[1] Outright monetary transactions.

Sources:

Data for all charts and tables come from CEIC and Bloomberg.

Recent research