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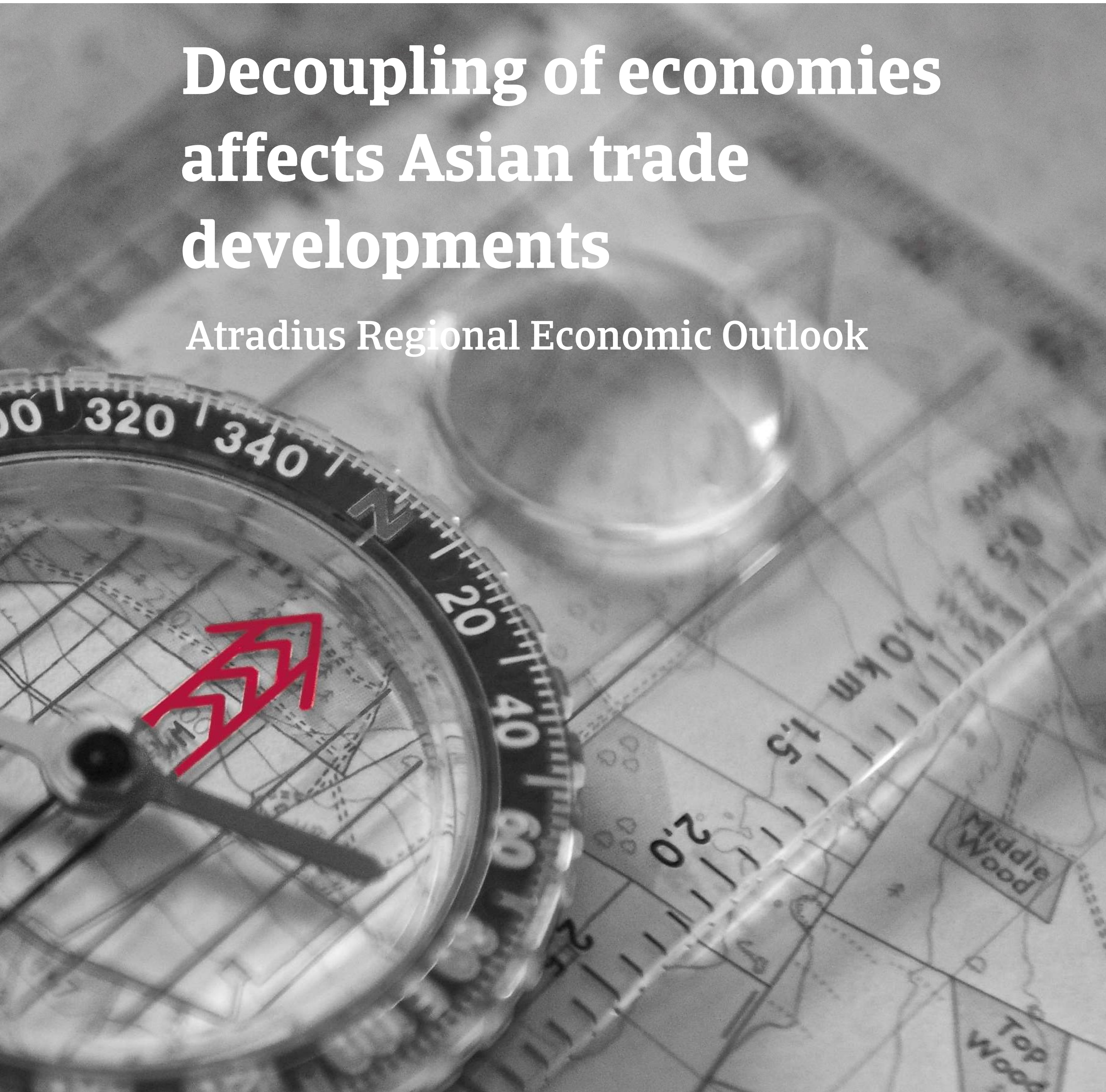
December 2020

# Decoupling of economies affects Asian trade developments

## Atradius Regional Economic Outlook



# Atradius Economic Research

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# Executive summary

**The Covid-19 pandemic and the ongoing trade war made 2020 an 'annus horribilis' for the world economy. For Asia, it was less so. The recession in most economies was less severe than in the rest of the world, due to successful containment measures and firm fiscal and monetary policies. Both factors will also play a role in the growth opportunities (which are reasonably good) for the region in 2021.**

**The initiated growth recovery is positive for foreign trade, but economic policies pursued by China and the new US administration have an impact as well. A gradual decoupling of economies, changing supply chains and free-trade initiatives will have both positive and negative consequences for foreign trade developments in Asia. On balance, we expect a promising year, but with some pitfalls.**

## Key points

- Economic recovery has started in most Asian countries, with underlying growth strongest in Vietnam and China. India has the weakest starting position.

- Thailand, Malaysia and China have supported their economies with more fiscal stimulus than other countries in the region. However, the Chinese authorities will restrain themselves now, in order to avoid a further increase of macro leverage.

- The new Five-Year-Plan means China will focus even more on domestic, consumer-led growth than before, and less on exports. Despite the external pillar in the 'dual circulation' strategy, China's aim to be less reliant on foreign technology and better equipped to external shocks will strengthen the international trend of decoupling of economies.

- With a new administration, the US will maintain a tough approach to China, albeit one that is more predictable and less confrontational. By working together with the EU, Japan and other allies, the Biden administration – avoiding the Trump administration's confrontational attitude – will probably be more successful in persuading China to introduce changes in trade, competition and other relevant areas.

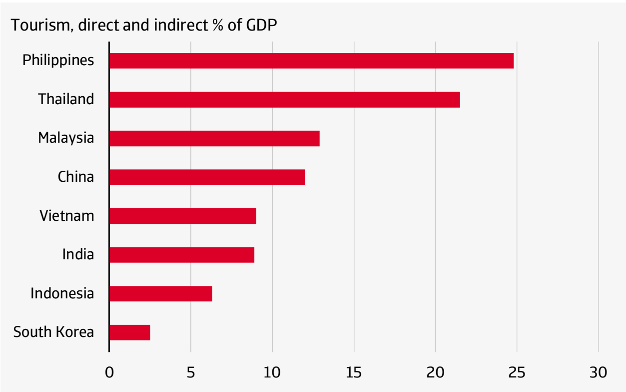
- Regional supply chains are changing because of rising wage costs in China and changing trade policies. Covid-19 will probably accelerate this process, because dependence on only one country has proven problematic. Based on relative attractiveness, Vietnam, Malaysia and Singapore stand out as the countries best positioned, but in different sectors.

# A gradual decoupling of economies

## An 'annus horribilis' for the world economy

The year 2020 has been an 'annus horribilis' for the global economy in several respects. The Covid-19 pandemic swept the planet like a shock wave, while the ongoing US-China trade war continued negatively impacting international trade. Asia[1] could not escape the negative shock, which hit its economies as hard as it came unexpected. Lockdowns and other measures took their toll on consumer expenditures and corporate investments, while remittances - an important source of income for several countries in the region – decreased sharply. Exports, which were under pressure already before the pandemic, fell across the board. The Philippines and Thailand saw a collapse of tourism.

1.1 Philippines and Thailand most hit by collapsing tourism




Source: Oxford Economics, Atradius

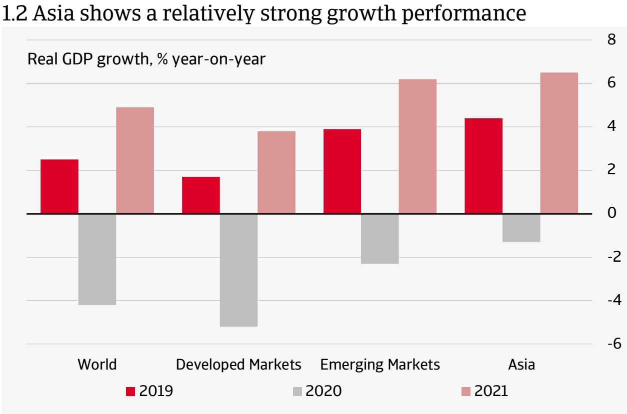
## Asia is less affected

While the region has been negatively affected, it has performed well compared to other regions. World GDP is expected to decrease by 4.2% in 2020 and to bounce back by 4.9% in 2021, while in Asia, economic activity is forecast to contract only 1.3% this year and to rebound about 6.5% in 2021. While there was a recession in the countries covered in this report, it was short and not as deep as in the rest of the world. China, the first victim of the virus outbreak, experienced its first quarter-on-quarter GDP contraction in many decades already in the first three months of the year, but saw thereafter a gradual recovery. For the other countries, the recovery started in the third quarter, after their economies hit the bottom in Q2. India and the Philippines were exceptions among the major economies in the region. In India, a stringent national lockdown and a prolonged first wave exacerbated the significant headwinds that already had a negative impact on growth prior the pandemic. In the Philippines, the authorities also battled relatively long to contain the rise in Covid-19 infections.

## A multi-speed growth recovery

The prospects for 2021 are positive. This is not only because the Covid-19 virus will probably be contained by the introduction of vaccines, albeit only in the course of the year. A return to full capacity will take a longer time because fear of infection and social distancing measures still put a brake on consumer spending. Travel restrictions will continue to dampen tourism next year, and goods exports still will feel the impact of weak demand from developed economies. The economic outlook depends on infection rates, containment measures and the policy response by governments and central banks. Differences between the various countries will lead to a multi-speed growth recovery in Asia. Although, like in 2020, the overall picture will be better than elsewhere in the world.

1.2 Asia shows a relatively strong growth performance



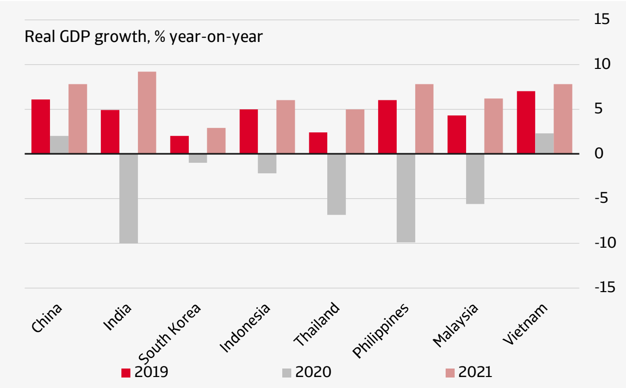

Source: Oxford Economics, Atradius

[1] The Atradius Regional Outlook Asia covers Asia, excluding Central Asia, the Middle East and Japan. The focus is on China, India, South Korea, Indonesia, Thailand, Philippines, Malaysia and Vietnam.

## Covid-19 not an obstacle for further economic recovery

Looking at the infection rates and containment measures, Asia is well positioned to rebound. According to data from the Johns Hopkins Coronavirus Resource Center as of 22nd November, Vietnam, Thailand and China rank among the lowest eight out of 170 countries concerning deceased per million inhabitants – much lower than countries in Europe and the Americas. South Korea and Malaysia have also registered much lower death rates, ranking only 145th and 143th respectively, with only roughly one tenth of the number of victims of many developed economies. Indonesia, the Philippines and India are performing worse, but still rank only 99th, 90th and 82nd. Evidently, the virus itself will not be an obstacle for further recovery of Asian economies. At first glance, it is remarkable that India and the Philippines are expected to have the highest growth rates next year, but this can be explained by the fact that they are inflated by the low growth base in 2020 and related pent-up demand. Underlying growth is strongest in countries that performed relatively well in 2020, such as Vietnam and China.

1.3 Covid-19 took its toll, but economic recovery has begun




Source: Oxford Economics, Atradius

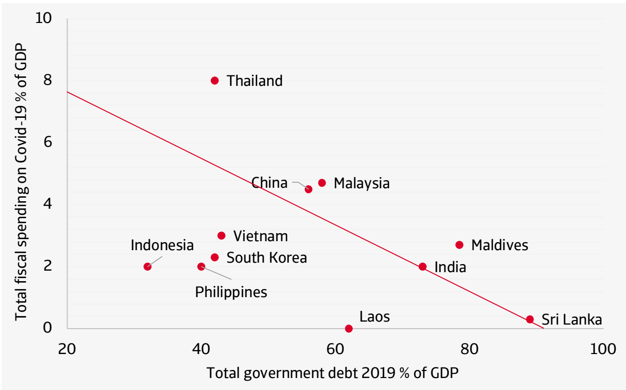
## Fiscal and monetary response varies from country to country

The economic outlook for individual countries also differs due to divergent fiscal and monetary measures. Relevant for monetary policy, across the board output gaps are large, with low inflation pressures. This provides leeway for some additional policy rate cuts (Malaysia), for measures to enhance monetary policy transmission channels and liquidity support (Indonesia and Thailand), or at least enables to stick to an already accommodative monetary policy stance (China, South Korea and the Philippines). With inflation remaining below target, Vietnam also has room to lower interest rates, but it can afford to wait because economic activity is picking up relatively fast. India is the exception, with upward price pressure limiting the room for monetary easing. Some further rate cuts are likely, but a lack of adequate recapitalisation of public-sector banks in the face of pre-existing credit strains will limit banks' ability to lend adequately to the private sector.

The picture is diverse for fiscal policy as well. In terms of additional spending and forgone revenue, Thailand, China and Malaysia have implemented the largest fiscal stimulus in emerging Asia so far. Thailand has announced to ramp up fiscal stimulus with an additional 14% to 15% of GDP in 2021. Malaysia's government will be even more expansionary next year, with fiscal measures totalling around 21% GDP, on top of current wage subsidies, cash handouts and other measures to support recovery.

The Chinese authorities, however, will restrain themselves in order to avoid a further increase of macro leverage. Local government bond issuance, which gave an impetus to growth earlier this year, is set to decrease. With about 55% of GDP, government debt is not overly high, but so-called 'augmented debt', which includes the central government, local governments and their financing vehicles, as well as other off-budget activities, is at a worrying level. It amounts to 85% of GDP according to the IMF's most recent pre-Covid-19 forecast, and probably more than 100% at the end of this year. Even more worrying is the huge debt pile of non-financial corporates (at about 160% of GDP), as these contain contingent liabilities. Household debt is lower but steadily rising to almost 60% of GDP. The risk of a systemic financial crisis is low, as debt is mainly financed domestically. Yet a renewed pick-up in credit growth could eventually lead to more pronounced financial stress, raising the risks of defaults and market turmoil in the coming years.

1.4 Divergent fiscal response to Covid-19 in first nine months of 2020




Source: IMF (September 2020), Atradius

Indonesia and the Philippines, both belonging to the fiscally more cautious countries in the region, have less room for additional stimulus packages. In Indonesia, the fiscal deficit has risen to 7% of GDP this year, and will remain at nearly 6% in 2021, despite the growth recovery. These figures stirred some debt sustainability concerns earlier this year, but the public-debt-to-GDP ratio will only reach a still manageable 40% before decreasing again next year. The Philippines also sees its fiscal deficit widening sharply, whereas the debt level will remain sustainable. However, in contrast to Indonesia, the authorities of the Philippines have had problems implementing the fiscal stimulus, which added to the weak growth picture this year. In India, fiscal spending related to Covid-19 has also been relatively low, and this will continue in 2021. The government will probably launch another fiscal package, including an infrastructure development programme. However, over the course of next year, it will gradually take care to consolidate the public finances because of the high debt-to-GDP ratio.

# New policies add to decoupling of economies

Besides Covid-19 and fiscal and monetary measures, economic policies in China and the strained relationship between Washington DC and Beijing will have an impact on the economic and foreign trade outlook for Asia. Important here is to what extent China's new Five-Year Plan and the US president-elect's policy intentions contribute to a decoupling of the US and Chinese economies.

## China: dual circulation with emphasis on technological self-reliance

Technological self-reliance, 'dual circulation' and a move to a sustainable and resilient economy are the key aspects of China's 14th Five-Year-Plan (FYP), of which an initial draft has been released end of October. Although the FYP does not make explicit references to it, it is clearly the intention of the Chinese Communist Party to reduce China´s dependence on other countries, especially the US. In a move to higher quality growth, the FYP puts strong emphasis on strengthening innovative capacity in the strategic fields of 5G, the 'internet of things' and cloud computing.

Next to reducing reliance on foreign technology, the FYP makes clear that China will pursue a gradual shift from export-oriented towards consumption-based economic growth, which already started more than ten years ago. The dual circulation concept, which is a key theme in the FYP, is about improving the domestic circulation of demand and supply with the intention to make the Chinese economy more immune against shocks, while at the same time going forward with market-oriented reforms and opening up. The domestic pillar, however, is dominant, whereas the external pillar is meant to reinforce the domestic growth strategy by attracting foreign direct investments (FDI) and portfolio inflows.

The Covid-19 pandemic is already contributing to the shift towards more domestic-led growth. China has been able to start the economic recovery in a period of still weak external demand. Even more importantly, the shift to domestic growth is reinforced by the US and other countries which aim to reduce their reliance on China. Following US restrictions on exports of high-tech products and direct investments to and from China, the UK, Australia and several EU countries have taken steps to block Huawei, fully or partially, from playing a role in their domestic 5G networks. Japan uses a subsidy scheme to encourage companies to move production away from China back to Japan or to other countries. For India, recent military skirmishes at the Himalayan border are a reason to introduce trade and investment restrictions on Chinese companies. The Covid-19 pandemic spurred European policymakers to recommend a reduction of the medical equipment sector's reliance on China by increasing onshore production. Therefore, a decoupling of China from a range of countries has set in. It is a gradual trend, and as long as many multinational companies are keen on having access to the huge Chinese consumer market, it will be only a partial decoupling. However, after a long period of globalisation in which the transfer of technology and know-how via trade and investment has been beneficial for China's productivity and GDP growth, further decoupling will probably reduce these growth rates.

## New US administration: still a firm stance on China, but less confrontational

It is expected that Joe Biden's election as president of the United States will lead to some major changes in foreign relations. Currently, it seems that US foreign and economic policies will be more predictable, less confrontational and focused on re-establishing ties with established allies such as the EU, Canada and Japan. During his presentation of candidates for various posts end of November, the president-elect indicated that he is strongly committed to multilateral cooperation. In addition to re-joining the Paris climate agreement and expressing renewed support for the World Health Organisation, the new administration is expected to pursue a multilateral approach, seeking closer cooperation with its allies on a common China policy. Like the US, Australia, Japan and the EU are increasingly concerned about China´s growing military and economic might, as well as about Beijing´s more assertive policies. Businesses have increasingly complained about unfair competition from Chinese state-owned companies and forced sharing of technological knowledge with Chinese partners. To achieve a level playing field in international trade and business, the US will not soften its currently determined approach in its relation with China, which has broad support among both Republicans and Democrats in Congress. However, the new administration will probably make less use of punitive tariffs as a bargaining chip. By practicing closer cooperation with its allies, the Biden administration will probably be more successful than the Trump administration in persuading China to change its policies on trade, competition and other issues.

While it will likely take longer for a revised China policy to bear fruit, the benefits of a multilateral approach and the end of trade wars will be favourable for international and Asian trade in the short term. Less uncertainty for companies about tariffs and sanctions - not only against China, but also against other countries - will have a positive impact on businesses' appetite to invest, both domestically and abroad. Some of the US trade restrictions affecting Asian countries may be rolled back, and a reinstatement of Indian and Thai exports under the US Generalised System of Preferences (GSP) is possible. Although the direct impact of unwinding the protectionist measures would be modest, it will be positive for business confidence.

Even more important could be that Biden is in favour of free-trade agreements. His election victory revives the hope for a potential re-joining of the Trans-Pacific Partnership (TPP), the trade agreement from which Trump withdrew even before it went into play. The remaining group of eleven countries (of which five are Asian countries, but not China), which in 2018 still started with the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), would likely welcome the US. US participation in CPTPP would be of strategic importance, serving as a counterweight against the RCEP (the Regional Comprehensive Economic Partnership), which started November 15th, after eight years of difficult negotiations. With 15 countries including China (but not India), and about a third of global economic activity, RCEP is the world's biggest trade agreement. However, it is less ambitious than CPTPP regarding coverage of areas such as environmental and labour standards, as well as rules for state-owned enterprises. RCEP is mainly focused on tariffs and rudimentary trade-facilitation measures.

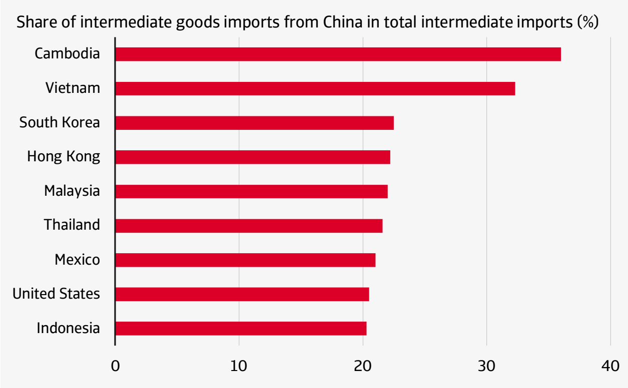
Despite a likely less confrontational US-China policy and a potential CPTPP re-entry, the trade and technology decoupling of the US and Chinese economies will gradually continue in the coming years.

## Covid-19 accelerating supply chain changes

The trend of decoupling, kept going by both Chinese dual circulation and trade policies of the US and other countries, has implications for the rest of the region. Most important is that companies will adjust their supply chains by relocating production. For example, the US is using tax incentives to encourage US companies to reduce their supply-chain reliance on China and to relocate production to the US. However, more often it will mean that US imports deflected from China will be produced in other Asian countries. For other countries that are encouraging companies to diversify away from China, this will be the case as well.

A temporary phenomenon, but probably with a lasting impact on changing supply chains, is Covid-19. Apart from the protectionist tendency in global trade over the last couple of years, stringent lockdowns and other containment measures in China early this year made international companies aware how dependent they were on one single country. OECD data shows that in one third of countries worldwide, the share of imports of intermediate products from China is more than 15% of total intermediate product imports. These countries – especially the US, Mexico and seven Asian countries that have a share above 20% – are vulnerable to supply chain disruption. The interruption in the supply of intermediate goods from China in early 2020 led to worldwide problems in the car industry, the pharma sector and in electronics manufacturing. This awareness will probably accelerate the change of supply chains in East and Southeast Asia, but it will not go quickly and will be only partial. Many companies are not only producing for the US and other Western markets, but also for Chinese buyers, and therefore have an incentive to keep production there. Capacity restraints are also putting a brake on moving supply chains to other locations in the region, because of China's large production size and the fact that several countries do not have the required infrastructure or labour supply. Diversification within supply chains, however, will take place, with companies moving specific operations (but not entire supply chains) to another country.

1.5 Countries relatively most reliant on China for intermediate goods

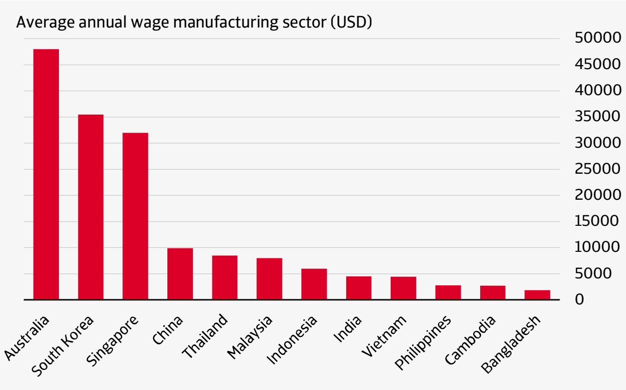



Source: OECD TiVA, Atradius

## Changing supply chains beneficial for Vietnam, Malaysia and Singapore

A more traditional but still important cause for supply chain change is rising wage costs in China and growing attractiveness of other countries in the region. In fact, wage costs in China still are much lower than e.g. Australia and South Korea. But they are rising quickly, making it attractive to shift low-skilled manufacturing out of China towards lesser-developed economies in the region. This shift, as mentioned above, will accelerate in the coming years by China's aim to create high-quality growth. Bangladesh and Cambodia stand out as countries able to raise their share of global production of textile and textile products, also because they are already producing for the biggest clothing companies in the world. However, Vietnam is most often the destination of companies relocating parts of the supply chain out of China. Besides low wage costs, the country benefits from its participation in several trade agreements (CPTPP, RCEP and a recent EU-Vietnam trade agreement) and policies favouring incoming foreign direct investments. The ease of doing business, for which Vietnam traditionally was ranking relatively poorly, is improving. With the US as the main destination, its exports of telephones and telecom equipment and consumer electronics are growing, whereas textiles and garments exports see a declining share of total exports.

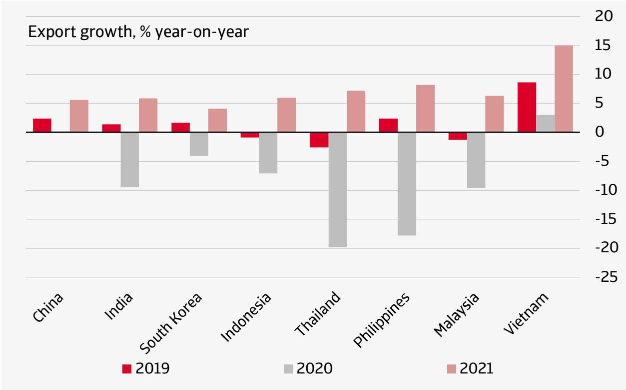
1.6 China's wage costs are low, but in Vietnam much lower




Source: JETRO Survey 2019, Atradius

Another country benefitting from supply chain adjustment is Malaysia. Its wage costs level is comparable with China's, but due to labour-force skills Malaysia's production capacity in medium skilled electronic manufacturing is rising. Besides that, the country is performing relatively well regarding quality of infrastructure and ease of doing business.

1.7 Good prospects for exports growth, with Vietnam standing out




Source: Oxford Economics, Atradius

Illustrative of the fact that not only wage costs are important is that Singapore is a large recipient of FDI inflows to its financial sector. This is supported by the troubled situation in Hong Kong. Political unrest in the Chinese Special Administrative Region has decreased this year, but protests could easily flare up again once the inhibiting effects of Covid-19 abate. Hong Kong´s economic outlook for next year is quite good with further recovery in store. However, the ongoing trade war and, in particular, an end of US preferential treatment for Hong Kong relative to China, threaten its role as a financial and trade hub. Hong Kong will remain a key gateway in and out of China, especially in the financial realm, but probably not as prominently as before.

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