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EAST ASIA: Seizing the Momentum to Reform

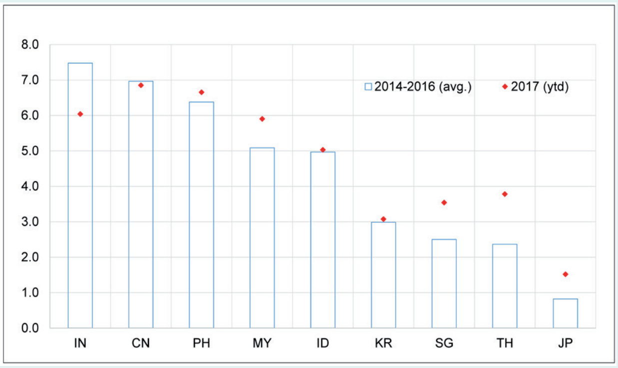
by Rully Prassetya and Lili Yan Ing

The year 2017 was a good one for most East Asian countries. As shown in **Figure 1**, almost all countries recorded higher year-to-date (ytd, Q1-Q3 2017) gross domestic product (GDP) growth compared to the average achieved in the past 3 years. Thailand, Singapore, Malaysia, and Japan recorded the largest pickup compared to average growth achieved in the past 3 years. The Philippines managed to grow even more strongly than its already high 3-year average, as did the Republic of Korea and Indonesia though their pickup was less strong than that of other countries in the region. India's GDP growth, by contrast, was considerably lower than over the past 3 years, due in part to the unexpected demonetisation in November 2016. China recorded a small correction to its recent years' average, as discussed below, and 2017 is expected to be the first year China's GDP growth accelerates, after a continuous slowdown since 2011. High-frequency indicators such as the manufacturing Purchasing Managers' Index (PMI) for Q4 2017 show the expansion continued in the last quarter of 2017. As shown in **Figure 2**, the manufacturing PMI in most countries continued to point to expansion in October and November, with stronger expansion recorded in November than in October. Overall 2017 GDP growth for the region is expected to be around its current year-to-date growth rate, which is higher than the 2016 rate. The bedrock of this trend, arguably, is the improving global economic conditions, an important factor for economies deeply involved in global trade such as those of the East Asian region.

Panel 1. Recent Economic Performance of the East Asia Region

Most Asian countries recorded higher GDP growth (ytd) in 2017 compared to the past 3 years.

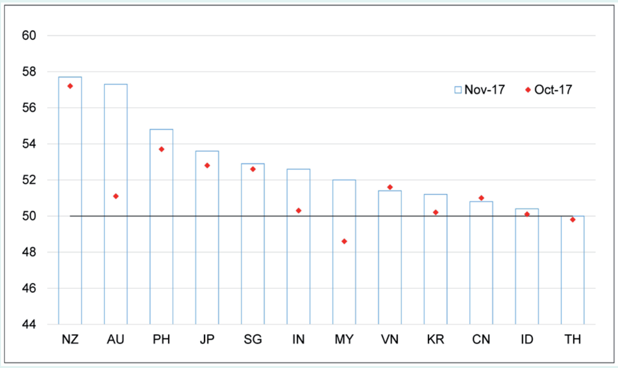
Figure 1. Real GDP Growth Rate in East Asian Countries



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

The manufacturing sector in most countries shows continued expansion in Q4 2017. November data shows stronger expansion than October.

Figure 2. East Asia Manufacturing PMI October and November 2017 Index



PMI = Purchasing Managers' Index.
Note: 50+ represents expansion of manufacturing sector compared to the previous month.
Source: Markit Economics.

Global Context

Global economic conditions were favourable in 2017. This is the first year global economic growth is expected to have picked up after a slowdown and weak recovery episodes since late 2011. The United States (US) economy saw its strongest rate of expansion in more than 2 years, at 3% (annualised) in Q3 2017, beating market expectations. Similarly, eurozone GDP growth in Q3 2017 at 2.5%, year-on-year (yoy) was the highest since 2011. And in November 2017, the unemployment rate in the US fell to 4.1%, the lowest in 17 years, while in the eurozone it fell to 8.8% (as of October 2017), the lowest in 9 years. The International Monetary Fund (IMF) estimates global GDP growth of 3.6% for 2017, the highest rate since 2012 (**Figure 3**). Furthermore, 2017 is also expected to be the year when GDP growth in advanced economies and emerging and developing countries picked up at the same time, ending years of an uneven, two-speed recovery. Trade volumes have also revived after 5 years of weak growth. As shown in **Figure 4**, exports and imports volume growth has been gaining pace since late 2016 and by mid-2017 had reached 5% (3-month moving average [3mma] yoy), a rate last seen in 2011. Moreover, the imports growth rate of advanced economies has somewhat recovered to around 4% (3mma yoy) after a declining trend since early 2015, suggesting a pickup in global demand. Correspondingly, emerging Asia's exports volume has seen a strong upward trend, reaching a growth rate of 8% (3mma yoy) by-mid 2017.

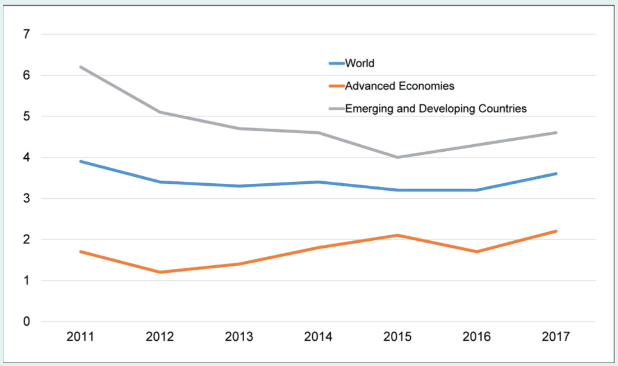
Most commodity prices continued to increase in 2017 albeit at a slower rate of growth than in 2016. The commodity prices rebound in 2016 continued in 2017 albeit at a slower growth rate and with negative growth for some commodities. As shown in **Figure 5,** of the major commodities produced in the region, copper price growth is still on an upward trend, whereas coal price growth has slowed though remaining positive. Prices of palm oil and rubber, important commodities in Indonesia, Malaysia, and Thailand, returned to negative growth in mid-2017. Nonetheless, compared to their lowest levels in late 2015, prices at the end November 2017 of coal, rubber, copper, and palm oil were still around 85%, 70%, 45%, and 25% higher, respectively. Overall, industrial commodities, such as metals, continue to be on an increasing price trend due to a pickup in demand coupled with supply constraints as a result of underinvestment over the past few years. Oil prices have also risen since late October 2017 to above US$60 per barrel, the highest level since mid-2015. This has been due to improving demand, production cuts by the Organization of Petroleum Exporting Countries and its partners, as well as political tensions in the Middle East.

On the financial front, asset prices have been increasing globally across many asset classes, including equities, bonds, and properties. As shown in **Figure 6,** world stock prices have been on the rise since the beginning of 2016. The Dow Jones (DJIA index) increased by 25% (ytd, as of 20 December 2017) and the MSCI Emerging Markets Index by 30% (ytd, as of 20 December 2017). The Dow Jones and Standard & Poor's 500 Index (S&P 500) continued to reach new record highs in 2017. Overall, global financial conditions have been accommodative, resulting in large capital flows into emerging markets and developing countries. Favourable developments in global demand in conjunction with loose financial conditions have led to improved economic performance in the East Asian region.

Panel 2. The Global Context

Global GDP growth is projected to pick up in 2017. The pickup is expected to be broadly shared, ending years of uneven recovery.

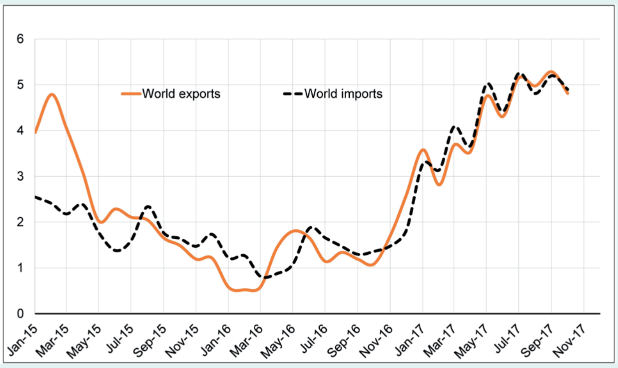
Figure 3. Global GDP Growth, year-on-year (%)



GDP = gross domestic product.
Source: IMF World Economic Outlook, various editions.

World trade volume growth picked up from late 2016, reaching 5% in mid-2017.

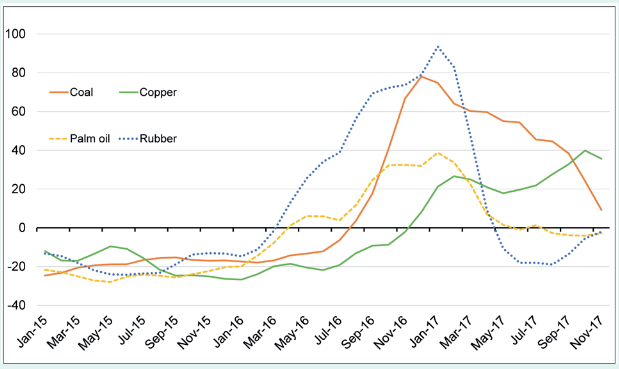
Figure 4. World Trade Volume Growth Seasonally Adjusted, 3mma yoy (%)



3mma yoy = 3 months moving average year-on-year.
Source: Author's calculation, CPB World Trade Monitor.

Commodity prices growth trend varies across commodities. Metal prices still grow positively, while agriculture commodities and coal have generally slowed.

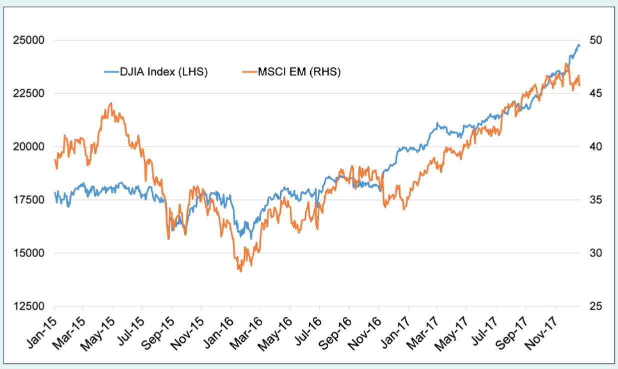
Figure 5. Commodity Price Growth, 3mma yoy (%)



3mma yoy = 3 months moving average year-on-year.
Source: Author's calculation; World Bank, The Pink Sheet, December 2017 edition.

Global stock market index rallied in 2017

Figure 6. Global Stock Market Index



DJIA = Dow Jones Industrial Average; MSCI EM = Morgan Stanley Capital International Emerging Market; LHS = left-hand side; RHS = right-hand side.
Source: Yahoo Finance.

East Asia Economic Performance in 2017

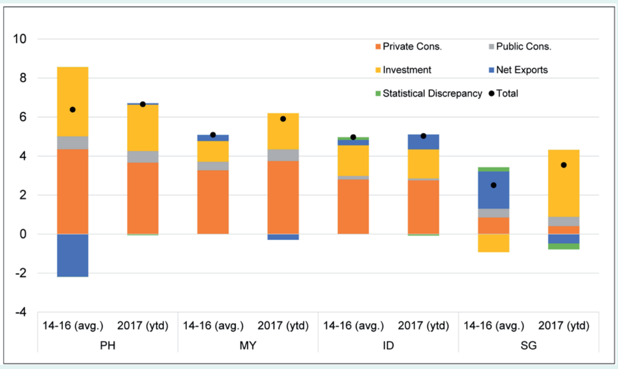
Almost all Southeast Asian countries recorded impressive economic growth in 2017. As shown in **Figure 1**, for most of them the year-to-date growth rate in 2017 was higher than their past 3-year average. **Figure 7** gives the composition of their GDP growth contributions. Overall, robust performances in 2017 were mainly driven by resilient domestic demand (particularly private consumption) and for some countries a higher contribution of net exports. *Malaysia's* year-to-date economic growth was stronger, at 5.9%, compared to its past 3-year average of 5.1%. In fact, its Q3 2017 GDP growth of 6.2% (yoy), is the strongest in 3 years' time. This was mainly due to resilient domestic demand (i.e. across the board improvements in private and public consumption as well as investment growth). *The Philippines'* year-to-date growth of 6.7% was also higher than its past 3-year average, despite its already high historical average of 6.4%. In fact, its quarterly growth rate surpassed 6% (yoy) for the past 10 consecutive quarters. Much of this improvement came from higher growth in exports compared to imports resulting in a smaller trade deficit. *Thailand's* year-to-date growth of 3.8% is also higher than its 3-year average of 2.4%. Its Q3 2017 GDP growth of 4.3% (yoy) was the highest in 4 years. As in the Philippines, much of this was due to an improved trade balance as a result of a recovery in exports. *Singapore's* year-to-date economic growth of 3.5% was significantly higher than its past 3-year average of 2.5%. This was due to a sharp increase in investment, offsetting smaller contributions of private consumption and net exports to GDP growth compared to the past 3 years. Its Q3 2017 GDP growth of 5.2% (yoy) was also the highest in 4 years. *Indonesia*, the largest economy in the region, recorded less impressive economic growth as it was hampered by many competitiveness issues compared with its neighbours. Its year-to-date economic growth of 5.03% was only slightly higher than its past 3-year average of 4.97%. Slower private and public consumption growth offset the improvement in net exports.

In other East Asian countries too, GDP growth was maintained. As shown in **Figure 8**, *Japan's* year-to-date economic growth of 1.5% is considerably higher than its past 3-year average of 0.8%. Its Q3-2017 GDP growth of 1.7% (yoy) was the highest in 2 years, and it marks 10 consecutive quarters of economic expansion, the longest run since the early 2000s. The economy in 2017 benefitted from stronger private consumption and higher exports. Japan seems to be on track to achieve its inflation target as excess capacity in the economy has been reduced. *The Republic of Korea's* year-to-date GDP

Panel 3. East Asia Economic Performance in 2017

Relatively stronger 2017 GDP growth across Southeast Asia was mainly driven by stable domestic demand and higher contribution of net exports.

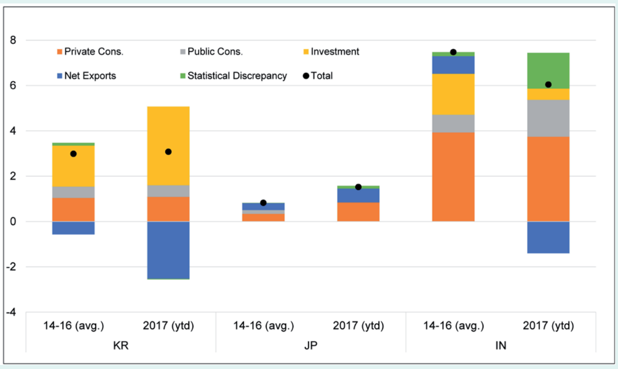
Figure 7. GDP Growth in Southeast Asia Contribution to growth (%)



GDP = gross domestic product; avg. = average; ytd = year-to-date;
PH = Philippines; MY = Malaysia; ID = Indonesia; SG = Singapore.
Note: The year-to date data covers Q1-Q3 2017.
Source: Author's calculation, CEIC Database.

Elsewhere in the East Asian region, GDP growth was also supported by robust domestic demand. Net exports' contribution increased in Japan, but declined in the Republic of Korea and India.

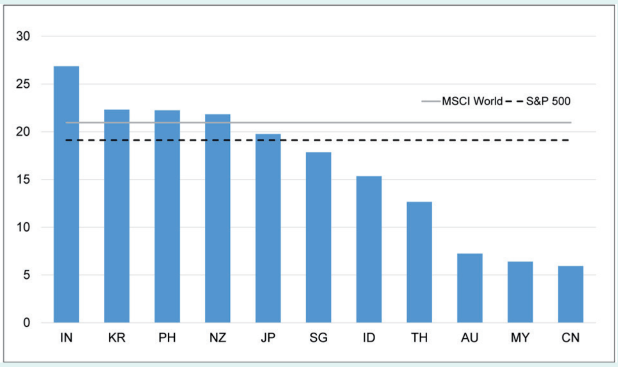
Figure 8. GDP Growth in East Asia COntribution to growth (%)



GDP = gross domestic product; avg. = average; ytd = year-to-date;
KR = Republic of Korea; JP = Japan; IN = India.
Note: The year-to date data covers Q1-Q3 2017.
Source: Author's calculation, CEIC Database.

Most stock markets in the region recorded double-digit return, with some recording higher returns than the global average.

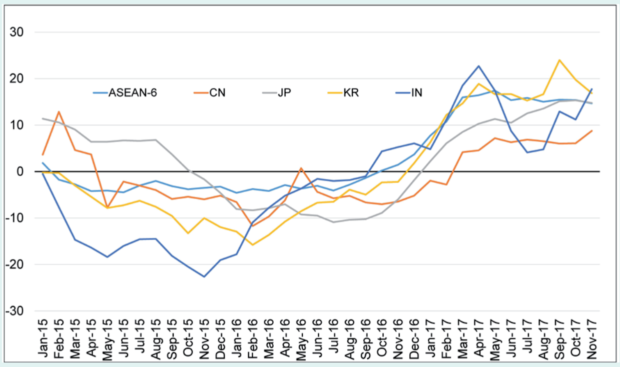
Figure 9. Stock Market Return 2017 in East Asia
ytd (%)



MSCI World = Morgan Stanley Capital International World; ytd = year-to-date; IN = India; KR = Republic of Korea; PH = Philippines; NZ = New Zealand; JP = Japan; SG = Singapore; ID = Indonesia; TH = Thailand; AU = Australia; MY = Malaysia; CN = China.
Note: as of 20 December 2017
Source: Bloomberg, Yahoo Finance..

Export growth rate has turned positive in all countries in the region since early 2017.

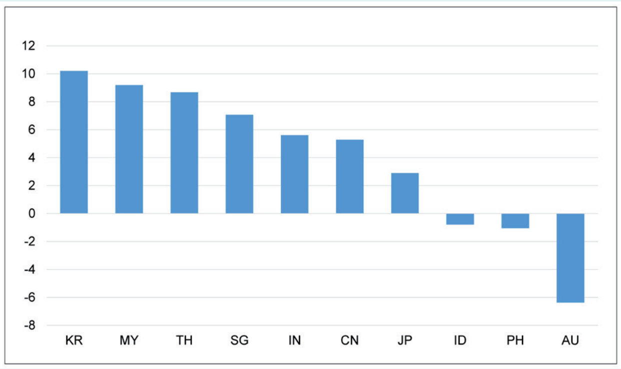
Figure 10. East Asia Export Value Growth Rate
3mma yoy (%)



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

Most currencies in the region appreciated in 2017.

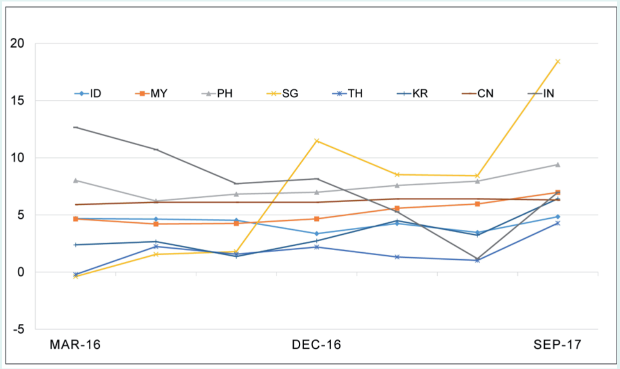
Figure 11. Change in Foreign Exchange Rate per US$1
ytd (%)



ytd = year-to-date; KR = Republic of Korea; MY = Malaysia; TH = Thailand; SG = Singapore; IN = India; CN = China; JP = Japan; ID = Indonesia; PH = Philippines; AU = Australia.
Note: Positive denotes appreciation; as of 20 December 2017.
Source: Bloomberg.

Except for improvements in the last quarter, the growth rates of the manufacturing sector in most countries generally have been stagnant or declining.

Figure 12. Manufacturing Value Added Growth Rate in East Asia
Real, yoy (%)



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

growth of 3.1% was also slightly higher than its 3-year average of 3%, due to strong investment growth, which offset the impact of a negative net exports contribution. *China's* year-to-date GDP growth of 6.9% was slightly lower than its past 3-year average of 7%. This is in line with expectations as the rebalancing of the Chinese economy leads to slower growth over time. Nonetheless the year-to-date growth of 6.9% suggests 2017 will be the first year of growth acceleration in China since 2010, reversing the recent trend. In *India*, the year-to-date GDP growth of 6% was lower than the past 3-year average of 7.5%, due to slower investment growth and a negative contribution from net exports. Nonetheless, the Q3-2017 figure of 6.3% was the first acceleration since the slowdown of growth in mid-2016. In fact, the various structural reforms the government initiated have improved business confidence and resulted in the first credit rating upgrades by Moody's in 14 years.

In terms of the financial sector, the region's performance has also been favourable. Many countries' stock markets – including those of India, Japan, the Republic of Korea, the Philippines, Thailand, and Indonesia – reached all-time highs at some point in 2017. **Figure 9** presents the year-to-date equity market returns of the countries in the region, with nearly all achieving double-digit returns. Some countries' stock markets, in particular those of India, the Republic of Korea, the Philippines, and New Zealand, outperformed the benchmark Morgan Stanley Capital International (MSCI) World index. And half of the region's countries also recorded higher returns than S&P 500 in the US. The high returns in equity markets in the region, amongst other factors, reflects the optimism about global economic conditions, progress made with domestic reform in some economies, better-than-expected company earnings, and to some extent the fear of missing out on the gains from the stock market rally amongst market participants. Turning to the bond market, the benchmark 10-year sovereign bond yield in the region also declined. The strongest decline was recorded by Indonesia (160 basis points [bps] or 20%, ytd, as of 20 December 2017), followed by Singapore (40bps or 17%, ytd), and Thailand (25bps or 10%, ytd). In China, by contrast, the yield increased (100bps or 34%, ytd) due to mounting concerns about excessive borrowing, as they did in the Philippines (120bps or 25%, ytd) due to concerns about rising inflation and higher bonds issuance.

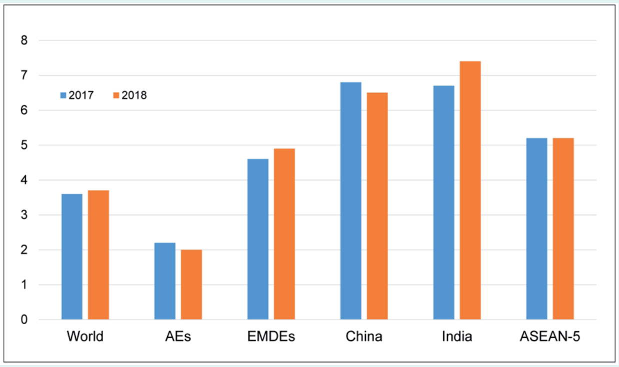
The regions' external position generally has also improved. The external trade performance of most countries of the region has improved. As can be seen in **Figure 10,** the export growth rate was positive for all countries in 2017 due to improved global demand, which resulted in an improved trade balance in some countries. Indonesia, for instance, on a year-to-date basis recorded its largest trade surplus since the collapse of commodity prices in 2011. Correspondingly, the current account balance of some countries such as Indonesia, Malaysia, and the Philippines also improved. Together with high capital inflows, this led to an appreciation of currencies in the region. As shown in **Figure 11**, most countries saw their currencies appreciate, led by the Korean won (by 10%, ytd, as of 20 December 2017) and the Malaysian Ringgit (by 9%, ytd).

Despite such favourable developments, the region needs to address various challenges to sustain the growth momentum and increase its resilience to external shocks. Each country has its own unique challenges, but most countries have faced the challenge of improving productivity (as highlighted in the July 2017 edition of EAU). Productivity growth has been declining for most countries since the early 2000s. Moreover, manufacturing sector growth in many countries has been flat in recent years. As shown in **Figure 12,** manufacturing sector growth has been roughly flat since early 2016 for Indonesia (around 4%), for Malaysia (around 5%; except in Q3 2017 when it grew by 7.0%), and for Thailand (around 1.5%; except in Q3 2017 when it grew by 4.3%). In India, the sector's growth had been in sharp decline, reaching 1.2% in Q2 2017, before increasing to 7% in Q3 2017. For commodity exporting countries such as Indonesia, commodity price increases in 2016 appear to have slowed in 2017, so efforts to diversify its economy to make it less commodity dependent would need to be accelerated. In fact, the lagging performance of its economy compared to the region testifies to its vulnerability to lower commodity prices and declining competitiveness, which has led to concerns of premature deindustrialisation. Many countries in the region also remain vulnerable to various global financial shocks, for instance those caused by interest rate hikes in advanced economies and political or economic policy uncertainty in the US. Safeguarding macroeconomic stability would benefit from an improvement in economic fundamentals. Across the region, improvements in the business environment (e.g. cutting red tape), investment in infrastructure and human capital, and policies to promote inclusive growth remain a top priority. On business environment improvement, some countries, particularly India and Indonesia, have championed significant reforms, which is reflected in an improvement of their ease of doing business index as compiled by the World Bank. Various structural reforms introduced by India appear to have also increased business confidence in the country. A more effective implementation of structural reforms would help countries in the region to sustain the growth momentum and reduce external vulnerability in 2018.

2018 Outlook and Risk

Continued acceleration is expected in 2018. The IMF and the World Bank forecast that global economic growth will be stronger in 2018 than in 2017, supported by pickups in real sector activities, including investment, trade, and industrial production. Business and consumer confidence are also expected to show signs of strengthening. According to the IMF's projections for East Asia (as shown in **Figure 13**), China's growth is projected to slow slightly, due to the rebalancing efforts, while India will continue its upward momentum, supported by various structural reforms. ASEAN-5 is also expected to maintain its expansion and the region as a whole will benefit further from an increase in global demand.

Figure 13. GDP Growth Projection, year-on-year (%)



AEs = Advanced Economies; EMDEs = Emerging Markets and Developing Economies; ASEAN-5 refers to Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam.
Source: IMF World Economic Outlook, October 2017.

Despite the favourable outlook, significant downside risks remain. *First* is the management of financial risk in China. As China's role in the global economy has increased, a shock to its economy could negatively affect the region through various channels, including trade, financial markets, and commodity prices. There has been a growing recognition of the risks attached to debt-fueled growth, which has resulted in excess capacity in China's factories and bad loans in its financial system. Fueled by an accommodative global financial system and a tightening of liquidity domestically due to a deleveraging drive, a record number of international banks have also channeled loans to China's companies. A disorderly adjustment could send waves of shock and contagion through the region and globally. In mid-2015, a devaluation of the renminbi (dubbed the Renminbi Tantrum) created financial turbulence in the Southeast Asian region. *Second* is the tightening of global financial conditions. Improving economic growth and labour market performance in advanced economies have prompted their central banks to begin tightening monetary policy. The Bank of England increased its policy rate for the first time in a decade in November 2017; the Federal Reserve increased its policy rate three times in 2017 and is expected to increase it three more times in 2018; and the European Central Bank will reduce the amount of bonds buying by the start of January 2018. This monetary tightening cycle could bring with it two risks. The first risk is a slowdown in growth. The pickup of growth in 2017 in advanced economies, as reflected in higher household consumption and business investment, could be attributed to low interest rate policies (i.e. negative real interest rates) by the central banks to stimulate the economy. Withdrawing this monetary stimulus could prove that the pickup in growth is not robust and resilient.

The second risk is macroeconomic instability in the region's emerging markets due to capital outflow. *Third* is an increased risk of asset price bubbles as a result of extra loose monetary policy since 2009. With the very low yields on many assets, investors have resorted to more risky assets, resulting in a decline of the spread between investment grade and junk bonds. In the US, for instance, the spread between US government bonds and junk bonds in early November reached 330bps, almost the lowest since the financial crisis of 2007–2008. The risk of a large asset price correction seems to be imminent, therefore. This concern has also further incentivised central banks in advanced economies to tighten monetary policy. The *fourth* risk is continued economic and geopolitical uncertainties affecting business confidence. This could arise as a result of uncertainty in US economic policy, for instance regarding the trade and tax policy reform; prolonged European Union-United Kingdom Brexit negotiations uncertainty; and rising geopolitical tension in the region.

The current period of economic upturn is an opportunity to accelerate reforms. Rather than being complacent, the region's policymakers should take advantage of the recent growth momentum generated by the economic upturn to accelerate domestic reforms and strengthen regional cooperation, so economic growth becomes more sustainable and the region's economies more resilient to external shocks. Economic growth remains fragile in some countries in the region, as can be seen for instance in India following demonetisation, and sluggish growth in Indonesia following a slowdown in commodity prices growth. Reform programmes would be much easier to implement during upswing periods, as there would be more leeway for any downward corrections that may be necessary. The focus of reforms should be on improving productivity, the business and investment climate, human capital, infrastructure, and other country-specific constraints.

For more information, please contact:
Rully Prassetya (rprassetya@gwu.edu)
Jaysa Prana (jaysa.prana@eria.org)

ERIA Economic Research Institute for ASEAN and East Asia

Sentral Senayan 2, 5th and 6th floors
Jalan Asia Afrika No.8
Senayan, Central Jakarta 10270, Indonesia
Tel: (62-21) 57974460
Fax: (62-21) 57974463
E-mail: contactus@eria.org