The Insight Bureau

From the Desk of...

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Who's afraid of the US downturn? Many Asia executives don't seem to be

With the world bracing itself for a major slowdown in the US, Asian executives are mostly upbeat. But not all are. Graeme Maxton, writer and commentator on Asia summarises:

The Insight Bureau has engaged in a series of conversations over the past month, taking the pulse of Asian CEOs. Both in one-on-one meetings and in small groups over lunch in Singapore and Hong Kong more than 30 regional CEOs across different industrial, consumer and service sectors expressed their views. The mood was generally bright. Everyone agreed that they thought the US, was already in recession and that it would get worse. But would it affect Asia?

For those in the increasingly troubled banking sector, the answer was a refreshing 'no'. Banks in Asia were generally less exposed to the debt crisis in the US most felt, and although there were exceptions and some specific concerns, any write-offs involved were likely, in most cases, to be small.

Similarly, those involved in base industries – from commodities and raw materials to manufacturing equipment and distribution – were almost completely upbeat. Their biggest problem was not of slowing demand but how to build the capacity and find the skilled staff to meet the growth potential. With long-term contracts and prices already fixed far into the future in the commodities sector, there was barely a cloud on their horizon. Only inflation and the value of the dollar kept them from sleeping too soundly.

The only sectors where nerves were increasingly frayed were electronics and consumer goods. The electronics sector, being so much more dependent on exports to the US and Europe, would see a major slowdown in Asia, bosses agreed. Indeed signs are already evident in Singapore and Malaysia. Many consumer goods companies were nervous too – those in shoes and watches and household goods were already seeing a drop in demand and exports. But those in car-making were not.

Perhaps the greatest area of dispute for these business heads was over local demand. Some CEOs felt that local consumption - and a shift in exports from the US to Europe - would keep their businesses on an even keel but others were much less sure. They predicted a sharp slowdown coming in Europe too and still-weak local demand, especially in China and India. Stormy waters ahead.

CEOs in South-east Asia talked much more about the potential of India than their counterparts further north. They saw it as a good bet for the years ahead. But their peers in Hong Kong were not so optimistic, feeling that India was still too far behind and had too many problems to solve. It was best for only a few very specific business sectors, they said. For them, China is where the action will be.

Certainly China will remain the major source of growth for years to come. Looming problems with electricity supplies, wage inflation, staff turnover, new tax regulations and environmental issues would no doubt limit growth. But as one CEO put it, 'everything is possible in China, it's just that nothing is easy.'

For now then, our clients in Asia agree that the region remains the brightest spot on the world map for their companies. Japan, the region's biggest economy, may be falling back into a deflationary recession -- but it has not really accounted for much of the region's growth for more than a decade. The rest of the region will continue to boom, with growth above 8% in China and (perhaps) India and above 5% in South-east Asia. The consensus was that this might only change if there were some sort of catastrophe -- perhaps over oil, perhaps because of rampant inflation or a sharp collapse in the value of the dollar.

Another consistent worry plaguing many regional CEOs however, was how to manage the expectations of their headquarters. For some, paradoxically, the problem was not of wildly stretched targets but of HQ telling them to cut back. Many HQs in the US and Europe are bleeding cash and facing recession. For bosses in Asia, staring at growing markets and opportunities, being told to slash investment was madness, they said. At the other extreme, some bosses were being told to expand too fast, reflecting the fact that many HQs are ordering Asia to make up the shortfall. Invest more! Make money faster! That, regional bosses agreed, was also likely to be foolhardy but a hard pressure to resist. Asia may be booming, but risk and return are usually matched and overly hasty decisions can cause years of trouble later.

Everyone wants to 'make hay while the sun shines', said one CEO. But it would be foolish to demand that the harvest comes too soon.

Graeme Maxton

So we then asked economist and business strategist, Dr. Yuwa Hedrick-Wong if are they right to be quite so confident and to help us understand the real foundations for such optimism

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CEOs in Asia seem quite confident about the future – should they be?

Yes. Asia's economic fundamentals today are the strongest of all the world's economies. Conditions in Asia are diametrically opposite to those of pre-'97 situation; Asian governments have too much foreign reserve as opposed to not having enough; Asian currencies are also appreciating as opposed to coming under speculative attacks; many Asian governments are running either a balanced budget or have surpluses; and Asia's exposure to foreign debts is minimal.

But should we not be concerned about Asia's export demand?

While Asia is still very dependent on exports, domestic demand (both public spending and private consumption) has become much more robust in recent years. There is quite a lot of room for governments to step-up public sector investment in 2008/09 in highly productive areas, such as infrastructure, to mitigate the slow down in external demand. Infrastructure investment in China, for example, has massive income and employment multiplier effects. Apart from Japan and Taiwan, fiscal effectiveness is high for most Asian markets (see chart). Consequently, growth will slow down in Asia but all key markets (except Japan which is in a cyclical recession of its own accord, not related to the global slowdown) will continue to grow, not fall into recession. China's growth in 2008 is expected to be in the range of 8-9% in real terms, for example. It is important to note too that the economic linkages between emerging markets (between Asia, Middle East and Latin America, for example) have expanded significantly in recent years. Hence the business cycles of the key economic regions of the world economy are moving out of phase more than ever before. This in turn means that a downturn in one region (the US, for instance) is likely to be met with counter-cyclical momentum in other regions as opposed to being a pro-cyclical dampener of growth.

Certainly, most CEOs in the region don't seem to be bracing for a major storm:

Well, the nature of the "storm" is different this time. The cause of the recession in the US is a slowdown in household consumption whereas the last recession (2000/01) was due to a collapse of business investment. This severe drop in investment had an immediate and massive impact on Asia's exports, concentrated in a few sectors, like office equipment and IT products etc. A drop in household consumption takes time to work through the economy and then slow down business investment. In the meantime, households shift to buying cheaper goods (hence booming Wal-Mart sales). So the US demand for exports from Asia is better supported in this recession firstly because households will shift to cheaper goods (which benefits Asian exports instead of more expensive alternatives such as local US production or imports from Europe) and secondly because business investment will slow down in a more gradual way. Many businesses will actually be pressured to outsource production to Asia faster and more extensively due to a squeeze on margins.

So what should we make of this so-called 'decoupling' of Asian economies?

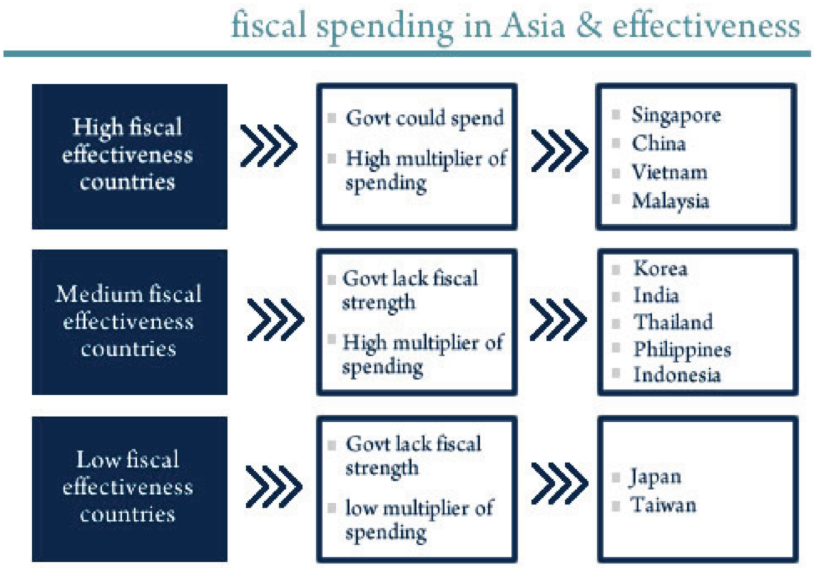
If by 'decoupling' we mean that Asia is somehow no longer connected to the US market (or to global demand) then clearly there can be no such thing. The important economic issue here is to understand how trade impacts economic growth. While the effect of trade on growth is superficially estimated in terms of ‘net exports’, this is both insufficient and misleading. In this kind of macroeconomic accounting, import is seen as a simple subtraction of growth but the reality is more complex and nuanced. Imports stimulate the development of logistics infrastructure, distribution networks, channels and marketing. This results in massive value-add, even if some imports are substituted for local production (note: imports are by definition higher value-add otherwise they would not be imported at all). Similarly for exports, know-how and technology transfers are the prerequisites for exports to grow significantly. The stimulative effect on infrastructure development cannot be under estimated; infrastructure, once built to facilitate exports, then becomes useful for domestic economic and business activities too. So the globalising trend in Asia (meaning Asian markets are actually more "coupled" than before) has therefore produced more competitive, robust and dynamic domestic economies which are better able to pursue "endogenous" growth independently of external demand. Hence we see the paradox of Asia being more "coupled" and more immune to external demand shocks at the same time.

Asia’s growth story has been largely a China story, so how worried should we be about China?

China will no doubt exert ‘substitution’ pressure on Southeast Asian markets, especially in the consumer electronics sector. However, China's infrastructure investment will remain strong, which will continue to benefit both commodities exporters like Australia and Indonesia and Brazil as well as industrial machinery exporters like Japan and Korea.

So even if we think it’s unlikely, what would it take for things to go horribly wrong?

To create the "perfect storm" the US recession would need to turn into a deep depression, and the EU would have to follow, and China's economy would need to tank. Frankly the probability of all three happening simultaneously is extremely small.



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About Graeme Maxton, Yuwa Hedrick-Wong and The Insight Bureau

Graeme Maxton is a writer and commentator on Asia business and is a regular contributor to The Economist on Asia. Dr Yuwa Hedrick-Wong is a global economist and business strategist who is an economic advisor to MasterCard Worldwide, Global Demographics and South Pacific Capital. The Insight Bureau represents a number of leading authorities on global and regional economics, world affairs, business strategy, emerging markets, industries and management, injecting deep insight into conferences, client forums and confidential briefings. Mr. Maxton and Dr. Hedrick-Wong form part of The Insight Bureau’s resource network that provides confidential, in-house briefings to senior executives, a service that helps achieve a better understanding of the world in which they operate, to manage certain corporate expectations and therefore ultimately to enable companies to make better business decisions. http://insightbureau.com/insight_speakers/profile/HedrickWong.pdf

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