



Global Economic Insight

The Global Financial Crisis and its Impact on Asia

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February 2009

The following was a speech given by Invesco Chief Economist John Greenwood to the Hong Kong Association Membership Forum on Tuesday 17th February 2009.

Until about six months ago Japan and Non-Japan Asia (NJA) had weathered the global credit crunch in reasonably good shape. Balance sheets in the Asian region were for the most part not overstretched (as they were in the developed economies of the West); debt ratios were low (with the exception of the ratio of Japanese government debt to GDP); the loan-to-deposit ratio for Asian banks was just 70% compared to over 100% in the US and Europe, and banks were generally better capitalised than their western counterparts; rates of return on equity had risen from the pre-Asian Crisis period; most countries maintained current account surpluses (except South Korea and India); and almost all Asian economies had strong foreign exchange reserves.

And yet, despite all these apparent advantages, Asian stock markets have declined much more severely than many others. For example, the Shanghai Composite is down by 61% from its peak in October 2007. In addition, over the past few months since October there have been dramatic and precipitate declines in reported economic data for many of the most dynamic of the East Asian economies. Moreover, those declines are now spilling over from exports and trade data into industrial production and GDP. Some domestic indicators have held up better than the trade data, but the signals are not promising.

The table below shows the astonishing decline in the recent growth rates of exports from some key Asian economies over the past three months. These declines are without precedent in the post-war history of the East Asian economies.

Exports % yoy	Nov	Dec	Jan
Japan	-26.5	-35.1	-46.0*
South Korea	-19.0	-17.4	-32.8
Taiwan	-23.3	-41.9	-44.1
China	-2.2	-2.8	-17.5**
Hong Kong	-5.3	-11.4	n/a

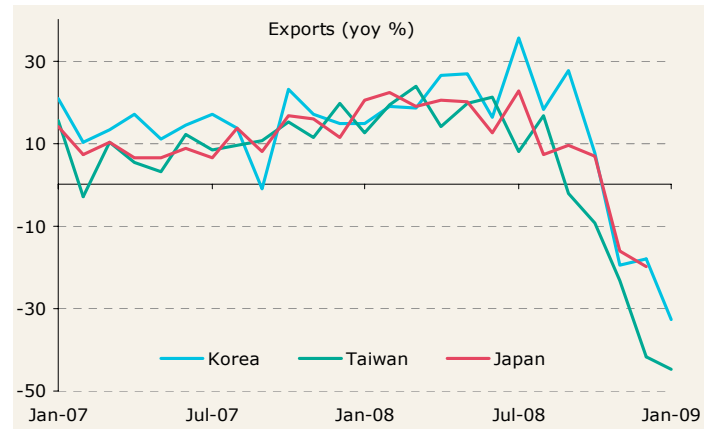
* 20-day data from MOF
 ** These figures may have been reduced by the timing of Chinese New Year
 Source: Bloomberg

Furthermore industrial production in Japan declined by 20.8% year-on-year in December, while in Korea the production of ICT products declined by 23.2%. So far we only have quarterly real GDP data for three of the economies: Japan's GDP declined by -3.3% quarter-on-quarter in Q4 (or -12.7% at an annual rate); South Korea's real GDP declined by -5.6% qoq (or -24.3% at an annual rate); even China's real GDP appears to have declined by -0.5% qoq (or at an annual rate of -2.0%). (Actually China does not publish the level of the real GDP, preferring to publish only the year-on-year percentage change which was 6.8% in 2008 Q4, but the qoq figure can be derived from an index value using the yoy rates of change.)

Based on the anecdotal evidence I have been able to gather from major Asian companies, air freight volumes in the region have roughly halved over the past six months. In Hong Kong specifically, tourist arrivals in Hong Kong are down by about 1% over the year, and unemployment has jumped to 4.6% compared with 3.4% in September. More tellingly, monetary

growth (HK\$M3) has declined in the past few months to negative yoy growth rates suggesting that Hong Kong will almost certainly experience deflation in 2009 (as will Japan, China and Singapore).

Sharp decline in export growth rates



Source: Datastream

Given this somewhat shocking background, there are three questions to ask:

- 1) Why has Asia been affected so severely?
- 2) Why has China apparently lagged the downturn elsewhere in Asia?
- 3) What is the outlook for Asian economies?

First, as Asia has become the manufacturing workshop of the world, almost all Asian economies have a heavy export-dependence. In most recessions, the sales of durable goods, which Asian economies specialise in, tend to decline more than the overall GDP. This is normal. But the declines in exports which I quoted above are unprecedented. What is the explanation?

To understand what is really happening, we need to understand the nature of the recession in the developed economies. The current recession differs from most post-war recessions in that it was caused not by any surge of inflation followed by central bank rate hikes and credit tightening (which is the normal cause of recessions), but by an excessive accumulation of debt, particularly in the household and financial sectors, and a parallel increase in asset prices, both of which proved unsustainable. The American economist Irving Fisher showed in 1933 that the most severe economic downturns were also the ones preceded by large accumulations of debt, and that debt deflation always caused a very severe economic downturn. The credit bubble since 2003 fits Fisher's analysis, and implies severe recessions in the developed economies, which in turn implies very severe downturns for Asia's export-dependent economies.

Second, why have China's economic data not turned down as steeply as the data in other Asian economies? Is it because China has a stronger economic growth rate and is therefore more resilient? No. The reason, I believe, is that China is simply further downstream in the Asian supply chain. Over the past two or three decades China has become deeply integrated into the Asian supply chain, providing generally lower value-added goods and services. As an example, consider the laptop. Typically the electronic chips will be designed and manufactured either in California, Japan or South Korea; the motherboard will be made in Taiwan; and the disc drive will be made in Singapore or Malaysia. Then all the components will be shipped to China for



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final assembly and packaging, before onward shipment to North America, Europe or other mainly developed markets.

This pattern of export processing or re-exporting by China has been verified by some new research conducted by the Hong Kong Monetary Authority. The HKMA obtained company level data from firms exporting to China, and then explored how much of what was sent to China was then re-exported elsewhere after processing in China. It turns out that more than half of all Asian exports to China are re-exported from China to other countries. Moreover, since China is positioned "downstream" from Japan, Korea, Taiwan and Singapore (at least in the electronics industry), the downturn in orders and production that has already struck these economies will soon hit China. It is only a matter of time.

In other words, China's domestic demand is nowhere near as strong as suggested by the superficial data on exports of Asian economies to China (or China's imports from Asian economies) might suggest. This also implies that China cannot act as a locomotive to provide enough domestic demand to enable other economies to recover based on the strength of spending in China. China, in short, cannot decouple – at least in the current business cycle.

Third, what are the prospects for Asian economies going forward? Unfortunately the near-term prospects are not encouraging. To my knowledge, only Japan at the time of the second oil crisis (1979-81) was able to decouple from other developed western economies and continue to grow, avoiding the recession that affected many developed economies at that time. Of course China, India and perhaps one or two other economies that are growing rapidly will continue to grow, but what matters is the growth slowdown. For China, which can grow at 8-10% in real terms on average, a slowdown to 5% or less is a recession. So while these economies will keep growing, their growth rates are sure to fall sharply. In addition, their recoveries will be highly dependent upon recoveries in the developed economies. No doubt Asia will be "first out of the gate" thanks to its inherent strengths – strong balance sheets, competitive industries and efficient infrastructure, but the problem is that the gatekeepers are the developed western economies. Only when the gatekeepers lift the gate (i.e. when they start to recover and increase their orders for manufactured goods from East Asia) can Asian growth resume the full potential that it has enjoyed in recent years.

In conclusion, it should be stressed that the current downturn does not in any way undermine the longer term growth prospects of China, India or the smaller East Asian economies. So long as these economies are "catching up" with per capita income levels in the developed economies, they are likely to grow more rapidly than economies in the OECD. But in the meantime there will be real issues of slumping orders, excess capacity and rising unemployment to deal with as a result of their substantial dependence on exports.

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