

ASEAN Business Cycle and Global Rebalancing

The ASEAN business cycle and
China's slowdown

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Lecture 21

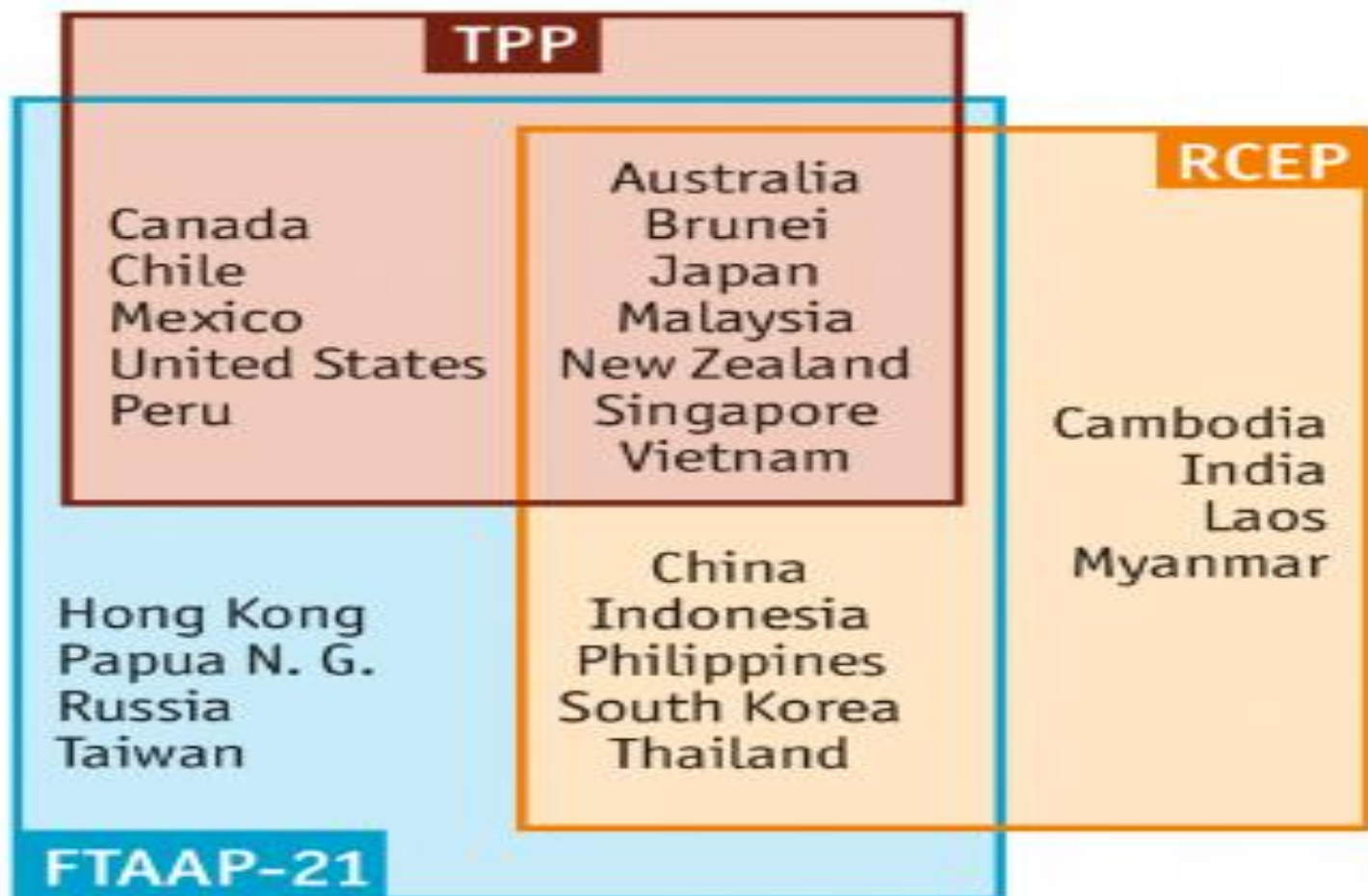
What are adjustment mechanisms for external disequilibrium?

Talk in trade: TPP's Asian cousin

- Today ministers of the ten-member Association of South-East Asian Nations and six others including China, India and Japan will wrap up discussions in the Philippines about a free-trade agreement called the Regional Comprehensive Economic Partnership.
- Talk of breaking down tariffs to boost trade and services will be plentiful, but consensus is unlikely.

Vendor diagram

Trade agreements



Source: "The Trans-Pacific Partnership and Asia-Pacific Integration", by P.A. Petri, M.G. Plummer, F. Zhai

Talk in trade: TPP's Asian cousin

- India is reluctant to dismantle barriers with its largest trading partner, China, with which it has a yawning \$53bn trade deficit.
- Singapore won't grant greater market access in services—India's biggest strength.
- Japan is keen to tighten screws on software patents that might stifle technological innovations in other countries.

Talk in trade: TPP's Asian cousin

- Mostly, though, RCEP, which accounts for a quarter of the world economy and covers 36% of global exports, is seen as a rival to the Trans-Pacific Partnership, led by America.
- Without strong political will among members of both alliances, expect plenty more foot-dragging.

Tough calls: the Bank of Japan

- Japan's central bankers, who meet on Monday and Tuesday, must wrestle with a familiar paradox: unemployment is low, but wage and price pressures are curiously weak. Inflation now seems unlikely to reach the Bank of Japan's target of 2% by March 2018, as it had hoped.
- After the BoJ introduced bold monetary easing in 2013, inflation picked up, but wages failed to keep pace, resulting in lower real (inflation-adjusted) pay.
- Now real wages are increasing, but only because inflation has ebbed. Japan has yet to enjoy the kind of mutually reinforcing wage and price gains that would permanently reflate the economy.

Step backs



Japan, consumer prices excluding fresh food
% change on a year earlier



Source: Thomson Reuters

Tough calls: the Bank of Japan

- The BoJ insists it can ease further if necessary. It recently resolved to keep the yield on ten-year government securities around zero, even as it remained ready to take short-term rates deeper into negative territory.
- This should allow it to ease policy without further harming the profitability of banks. That, at least, is the theory.

Angle of attack: the Fed meets

- America's central bank will probably signal today that it intends to raise interest rates in December. It is keen to tighten policy rather than risk overshooting its 2% inflation target.
- Excluding food and energy, prices are 1.7% higher than a year ago, according to the Fed's preferred index. But a rate rise now is unlikely.
- It would catch markets off-guard, and would come while economic growth is still gravely threatened by the prospect of a Donald Trump presidency.

Below the bar

US core inflation*, % increase on a year earlier



Source: Thomson
Reuters

*Personal consumption expenditures
excluding food and energy

Angle of attack: the Fed meets

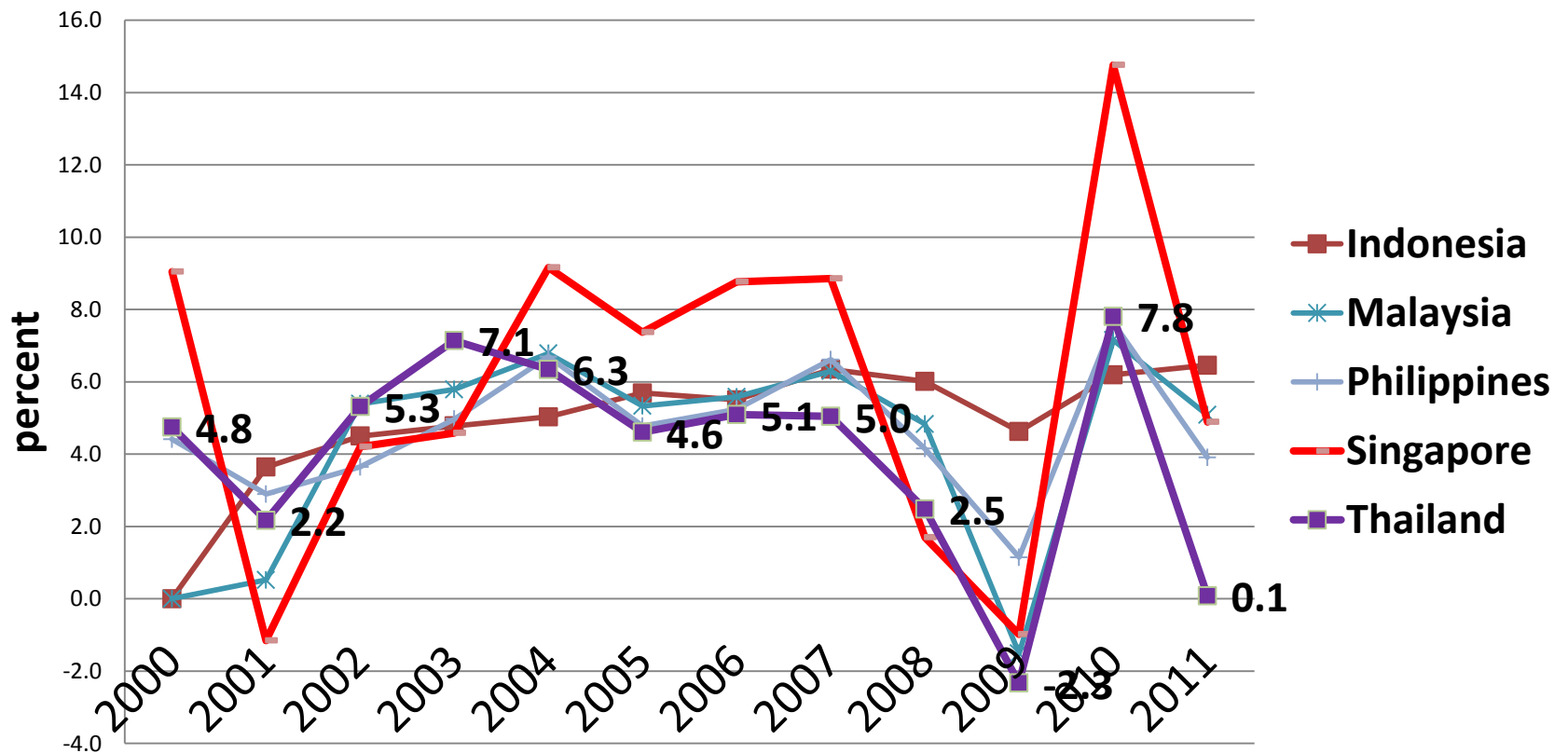
- There is more than a two-thirds chance of rates rising by the end of the year, according to futures prices.
- Doves are nervous. In the past, the Fed has sometimes raised rates too keenly, to the economy's cost.
- And, while traders expect inflation to rise from levels earlier in the year, some surveys say consumers' inflation expectations are falling.
- Uncertainty abounds. Expect the Fed to take only baby steps.

Main themes

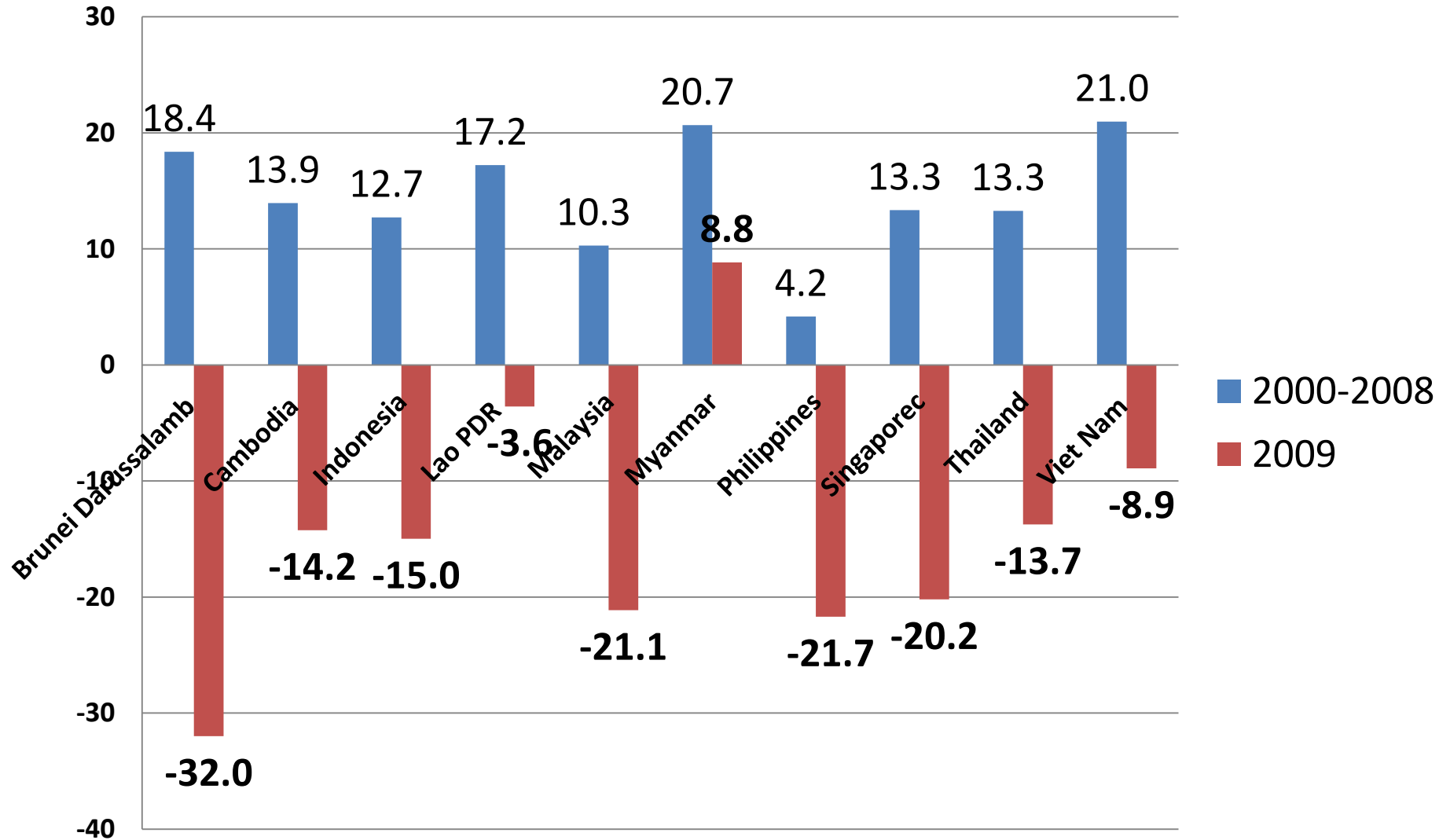
- Current account disequilibrium
- Determinants of investment-saving gap
- Role of exchange rate adjustments
- Policy responses to current account disequilibrium
- Impact of China slowdown
- Global rebalancing

ASEAN Growth Synchronization

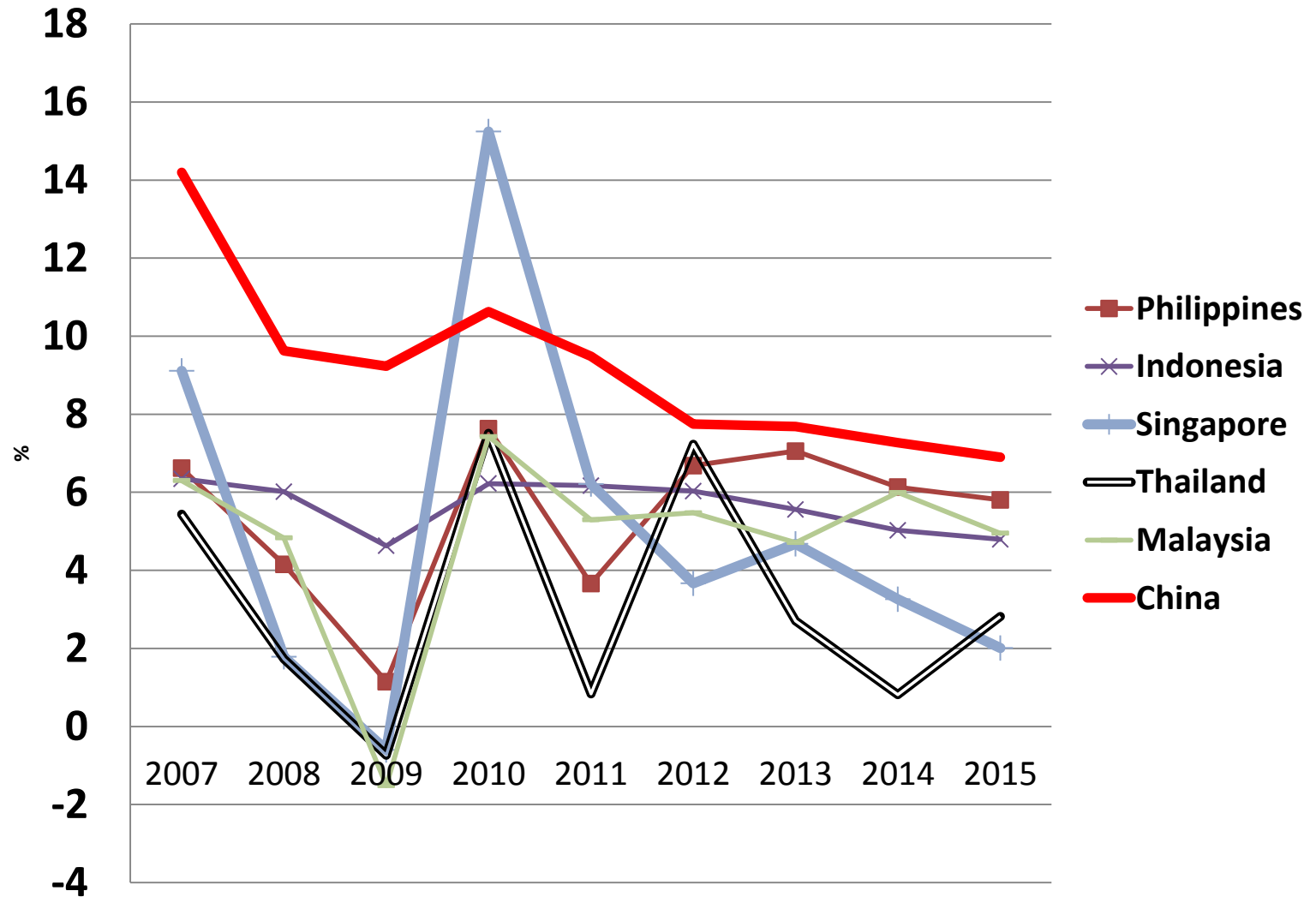
GDP Growth: ASEAN 5



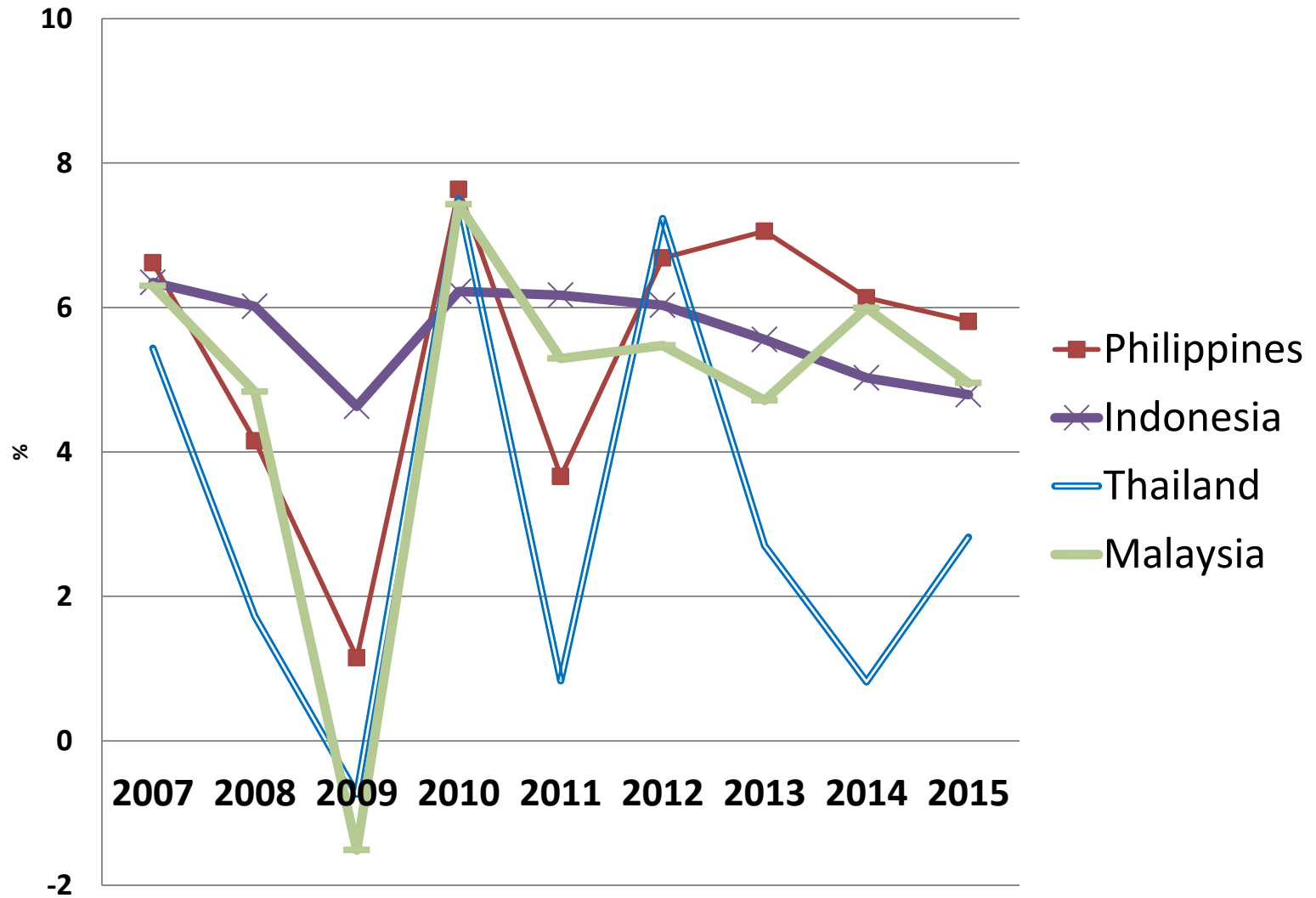
Impact of GFC on Exports (% change)



China and Asian-5 Growth Rates 2007-2015



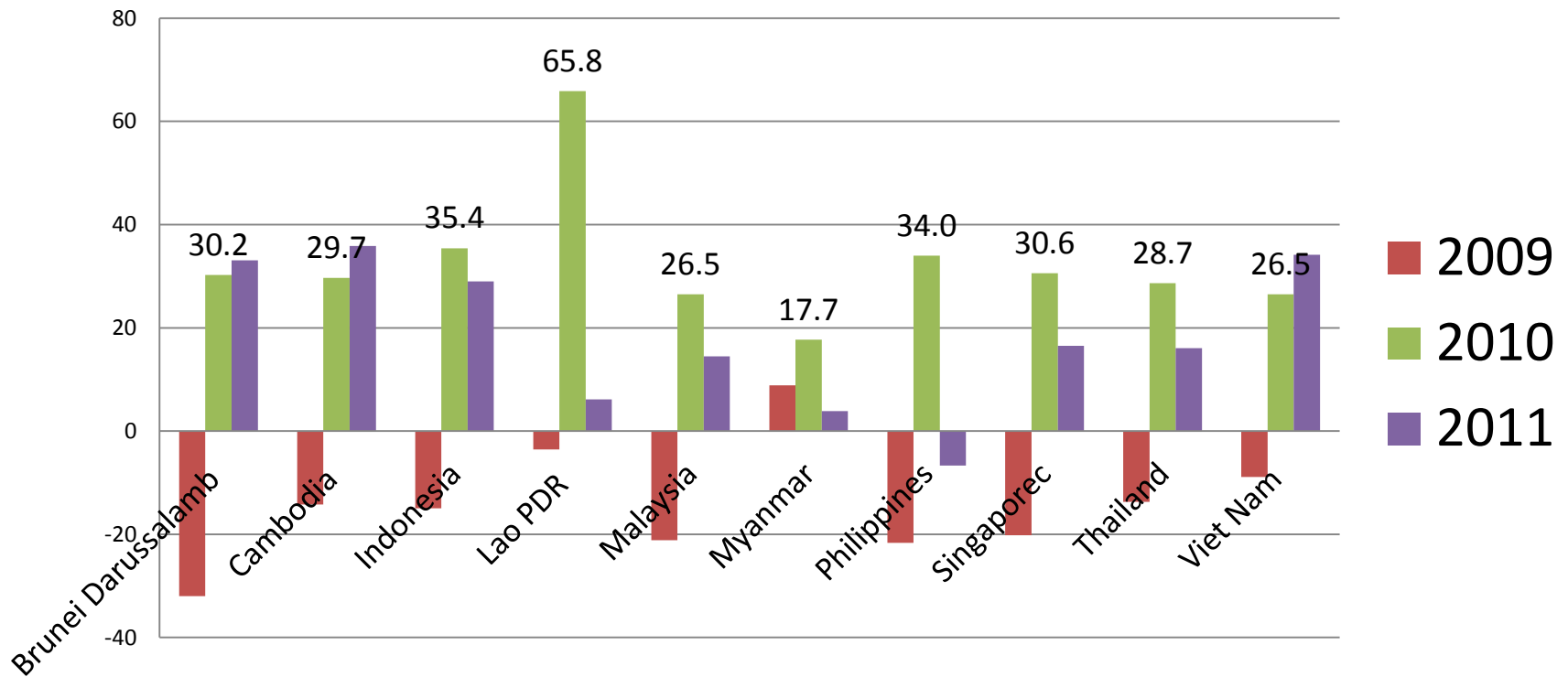
Asian-4 Growth Rates: Thai Volatility



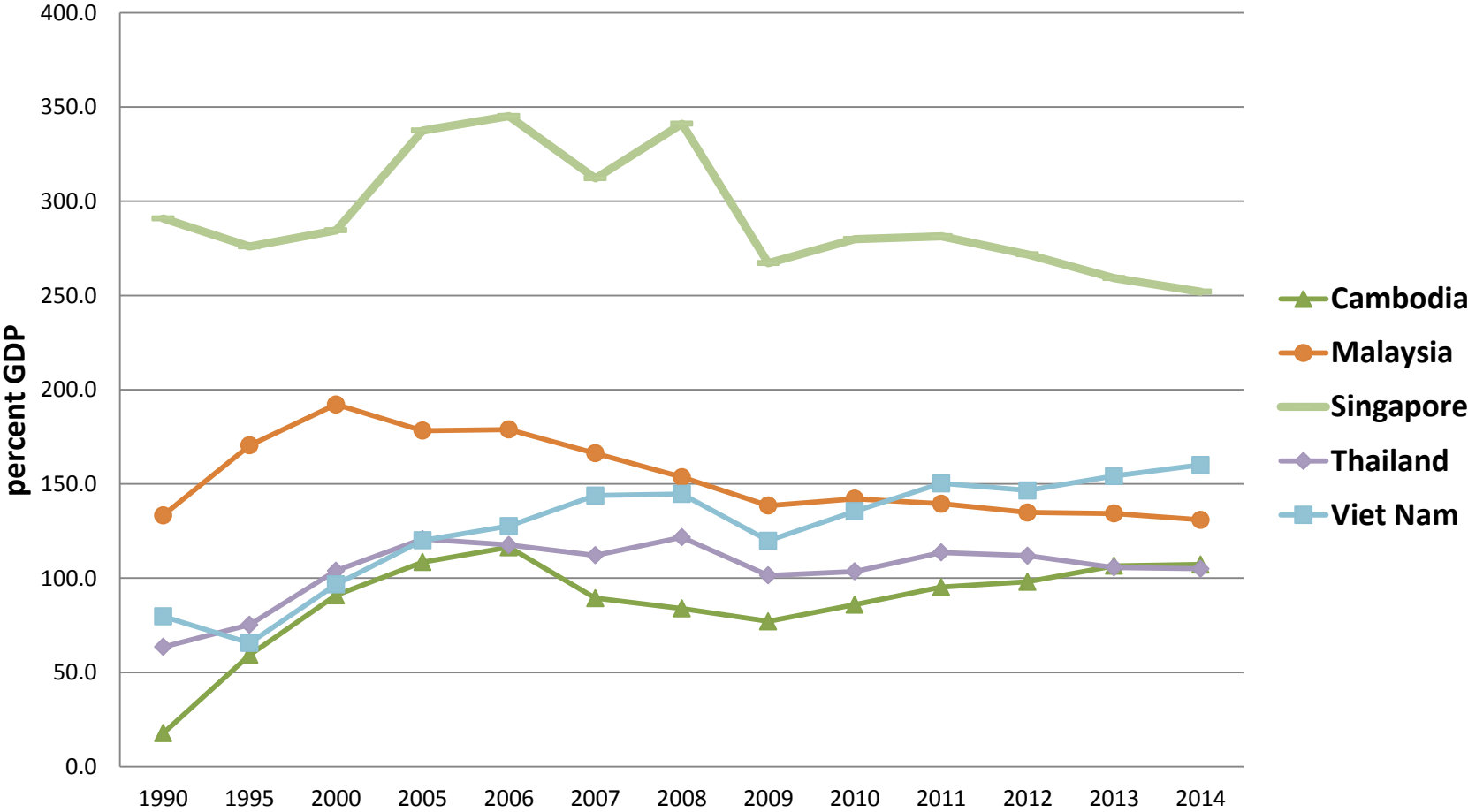
What do ASEAN have in common?

A sharp rebound after the GFC in 2010 and 2011

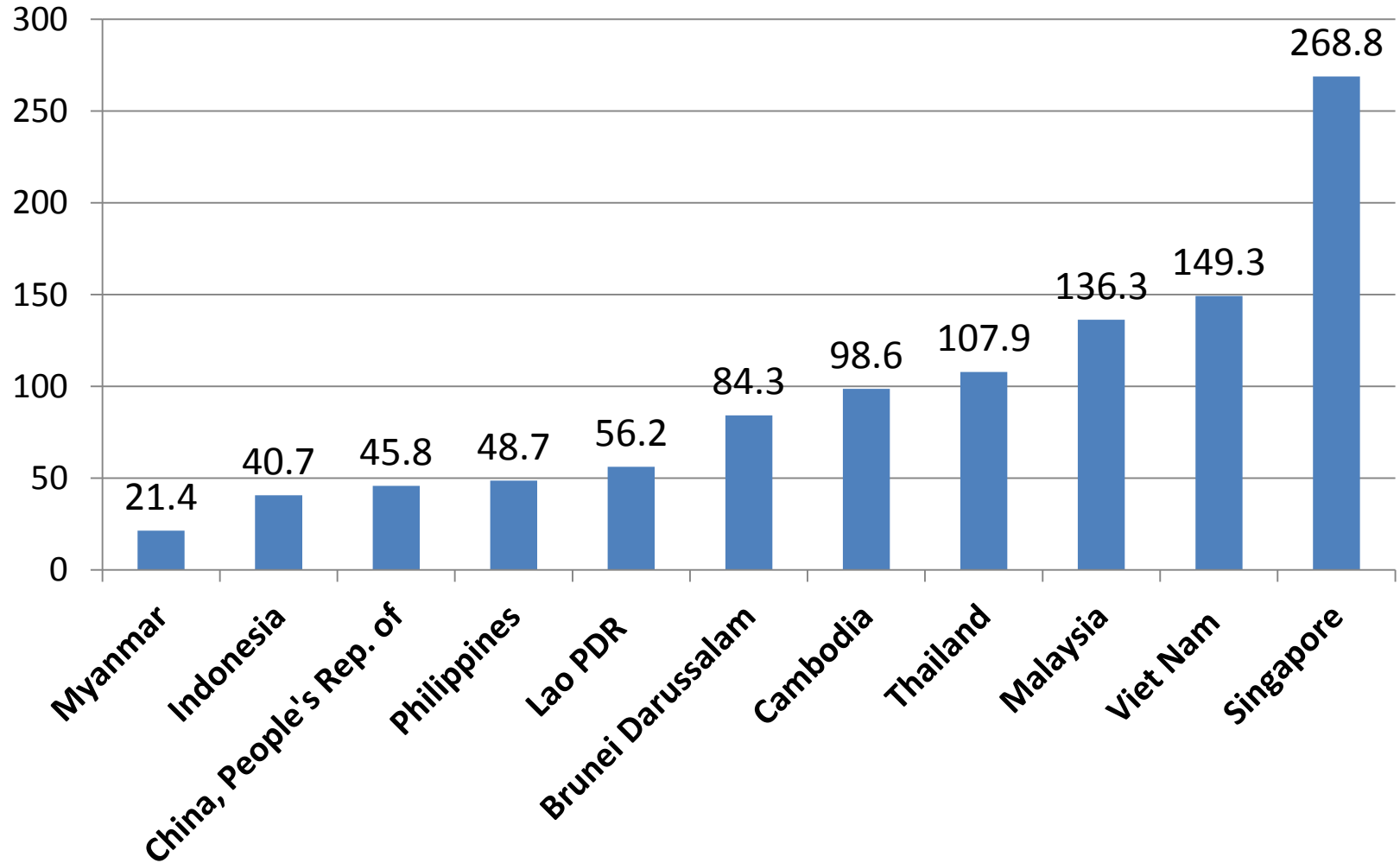
Impact of GFC on Exports (% growth)



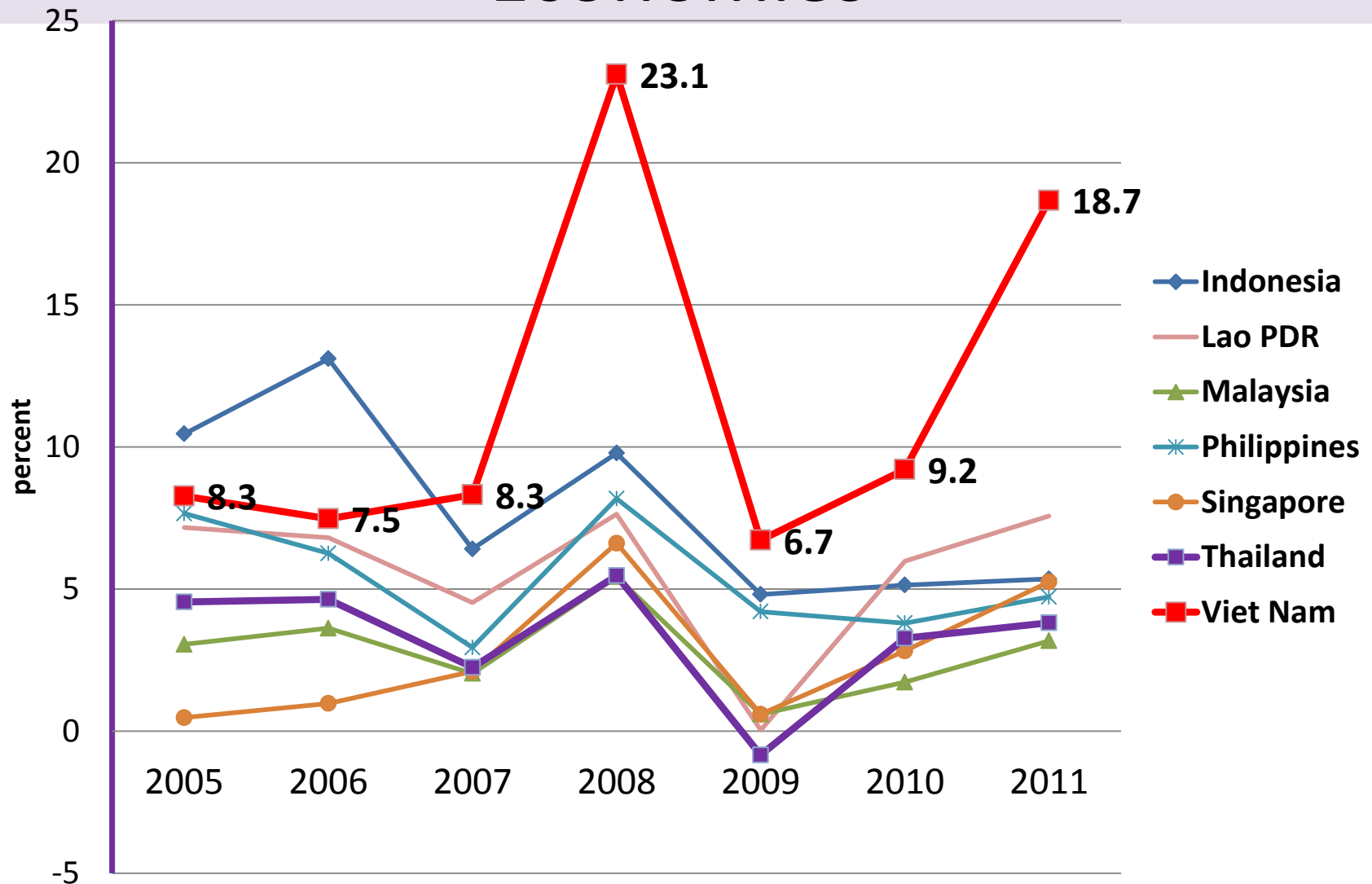
High Trade Exposure ASEAN Countries



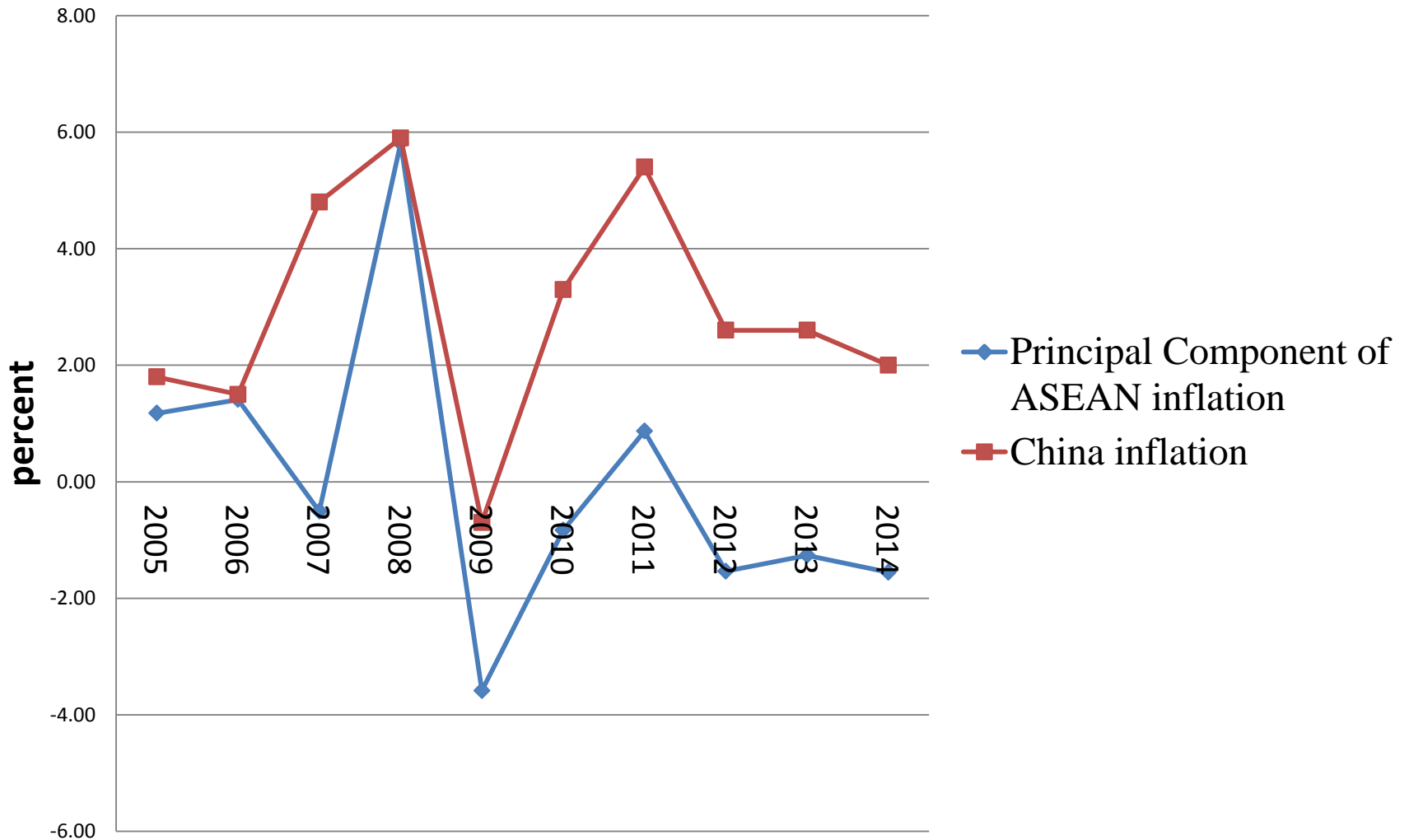
Average Degree of Trade Exposure 2010-2014



Inflation synchronization in SEA Economies



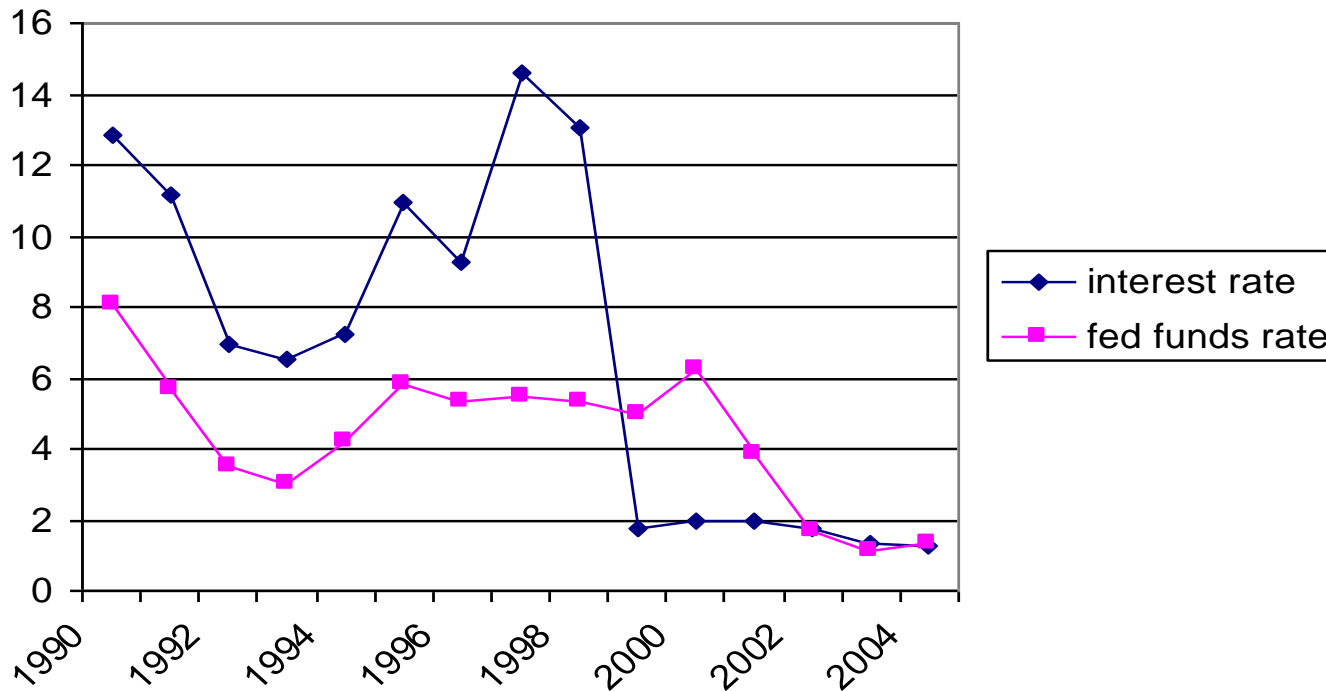
Inflation Synchronization: China and ASEAN



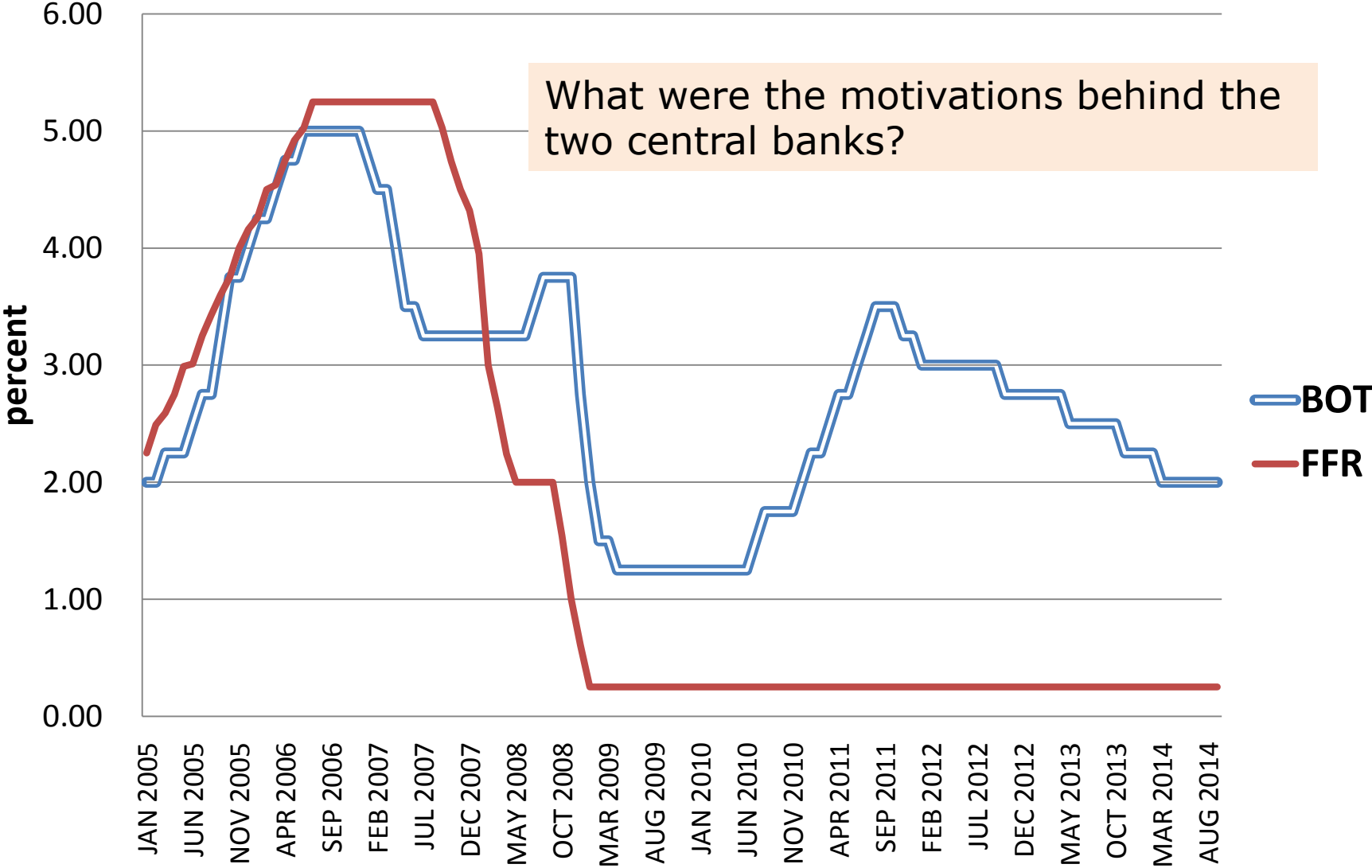
Widening and narrowing the interest gap (1990-2005)

Impact on Thailand's capital inflows

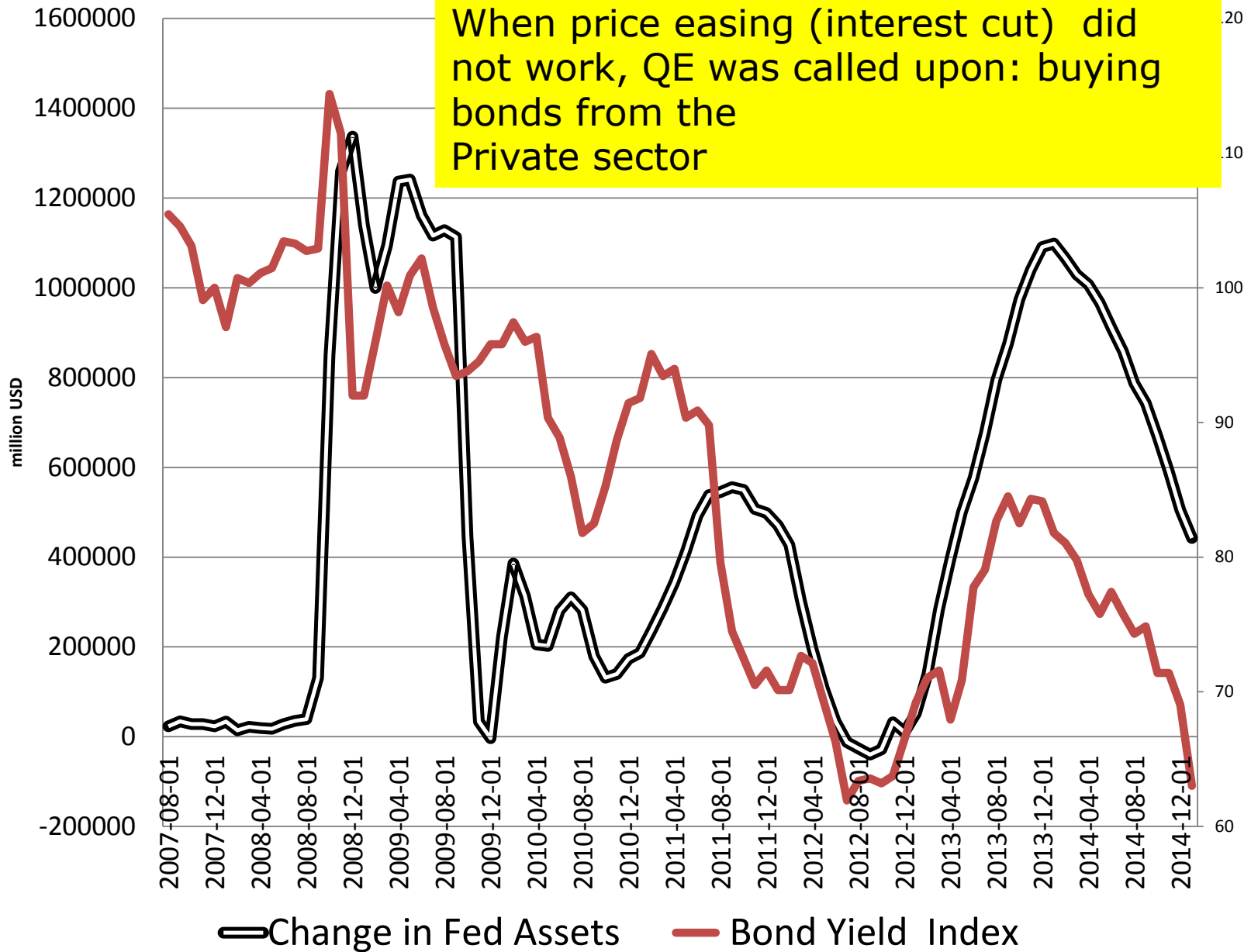
Money market interest and fed funds rates



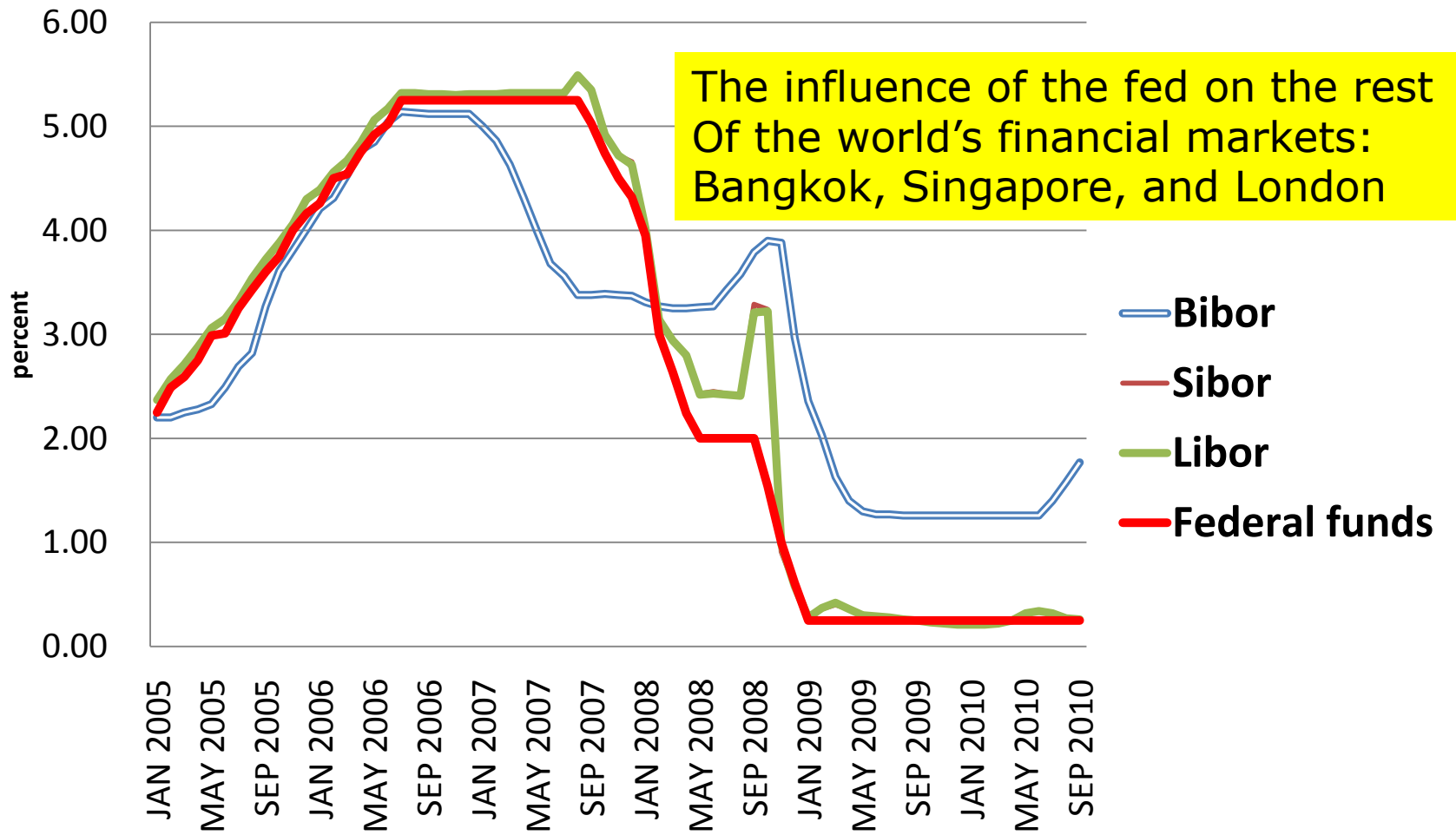
BOT policy rate and Federal funds rate: Widening gap after the GFC



Quantitative Easing and Corporate Bond Yield in the US



Interbank offered rates (IBOR): Jan 2005- Sep 2010 (Maturity: one week)



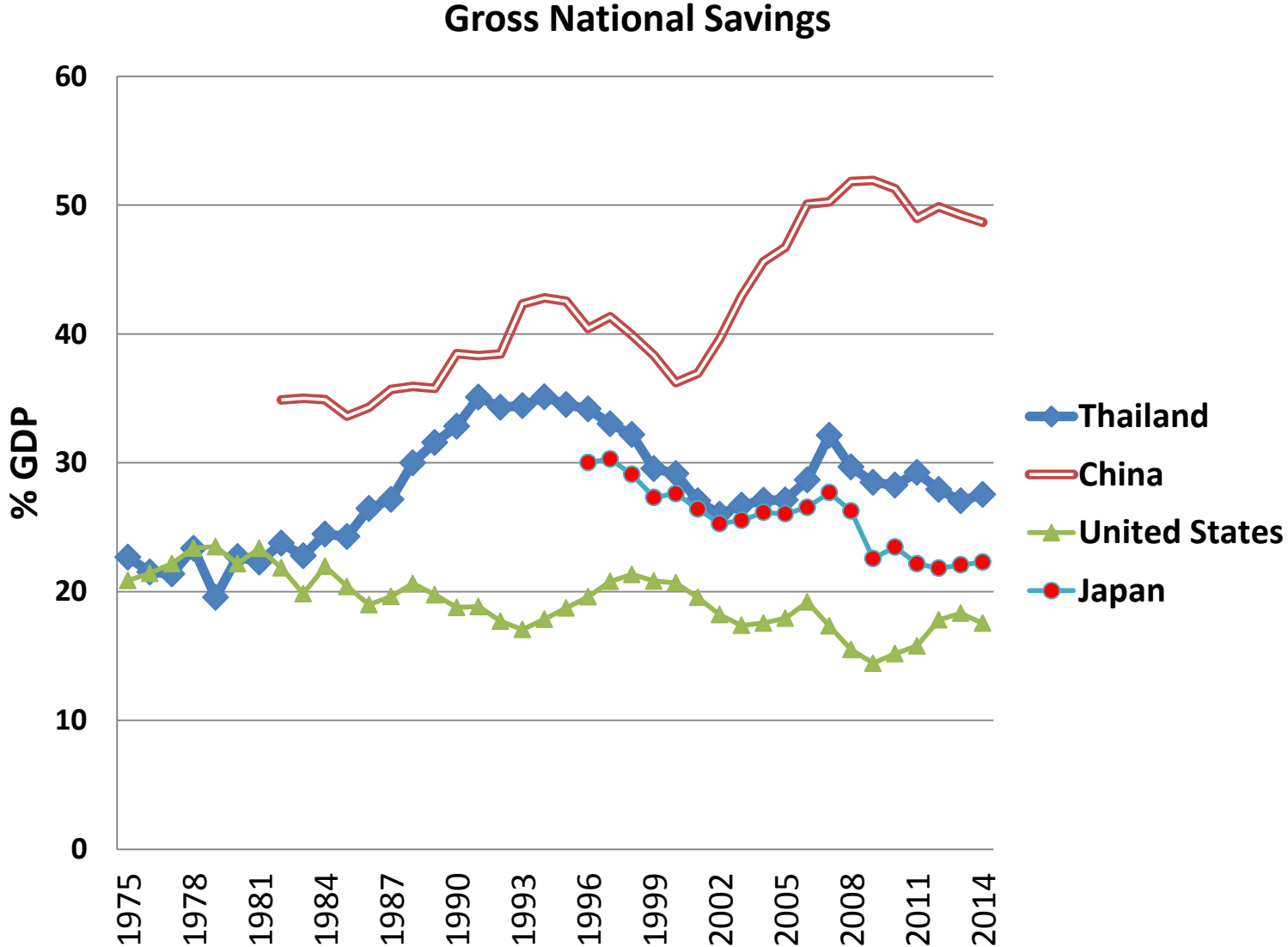
Financial globalization

- Short term interest rates are closely related, reflecting free capital movements, dictated by the law of one price.
- Singapore's money market is more closely related to London, when compared to Bangkok's.
- Short-term money markets are less volatile in Bangkok, indicating higher degree of intervention by the BOT through adjusting its key policy rate.

Saving and Output growth rates

- $S_t = \alpha + \beta Y_t$
(implied by absolute income theory of consumption)
- $(S/Y)_t = \alpha/Y_t + \beta$
- $s = \alpha/[(1+g)Y_{t-1}] + \beta$
- s = saving rate, g = growth rate
- Since $\alpha < 0$, $\partial s/\partial g > 0$
- A positive impact of growth on saving rate.

Gross savings are calculated as gross national income less total consumption, plus net transfers.



$$I/Y = \alpha + \beta(S/Y) + \varepsilon$$

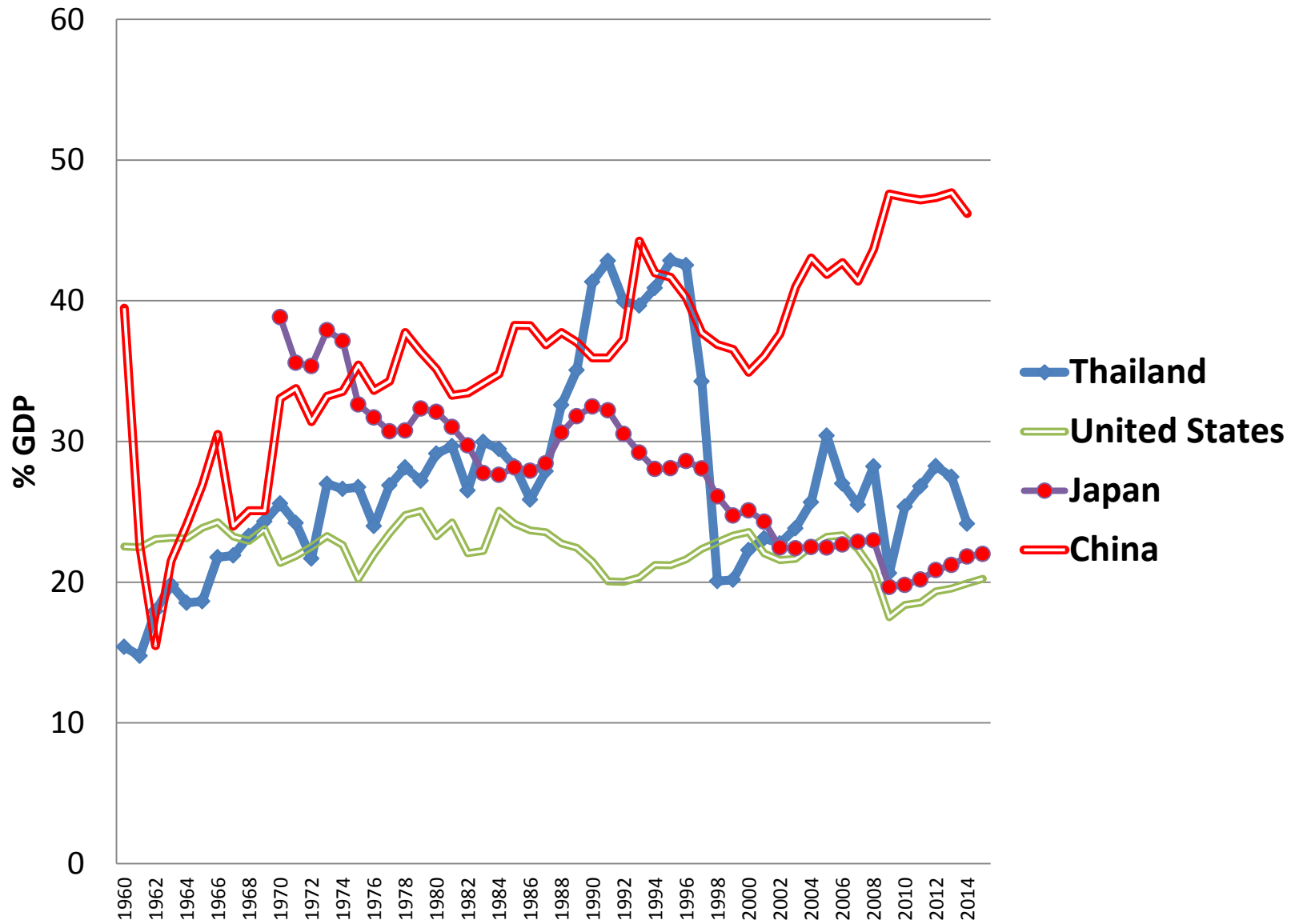
High savings lead to high investment

- Martin Feldstein and Charles Horioka (EJ 1980)

"with perfect world capital mobility, there should be *no relation between domestic saving and domestic investment*: saving in each country responds to the worldwide opportunities for investment while investment in that country is financed by the worldwide pool of capital."

- In a cross-section study:
if capital mobility is perfect, The estimated coefficient $\beta=0$

Capital Formation Expenditures (I/Y)

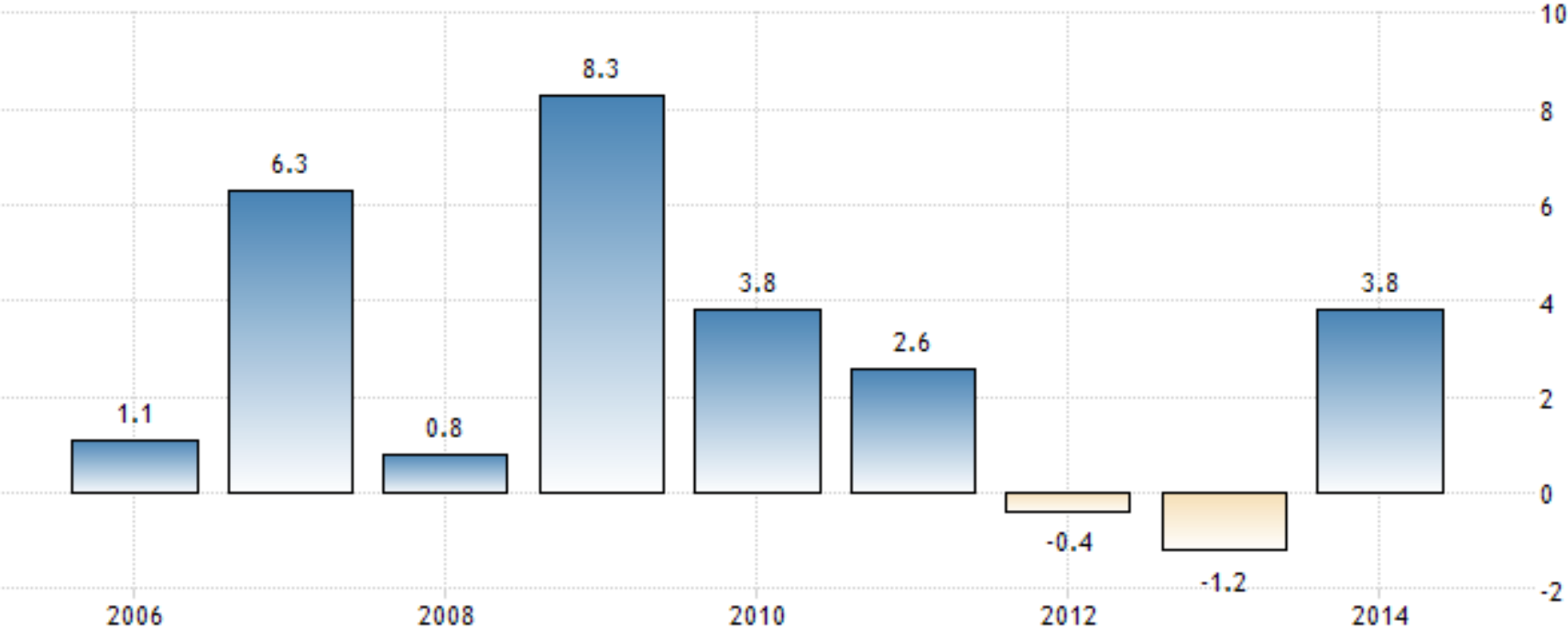


Current Account Deficit

- The Current account balance as a percent of GDP provides an indication on the level of international competitiveness of a country.
- Usually, countries recording a strong current account surplus have an economy heavily dependent on exports revenues, with high savings ratings but weak domestic demand.
- On the other hand, countries recording a current account deficit have strong imports, a low saving rates and high personal consumption rates as a percentage of disposable incomes.

Thailand recorded a Current Account surplus of 3.80 percent of the country's Gross Domestic Product in 2014. Current Account to GDP in Thailand averaged -0.73 percent from 1979 until 2014, reaching an all time high of 12.70 percent in 1998 and a record low of -8.30 percent in 1990.

THAILAND CURRENT ACCOUNT TO GDP



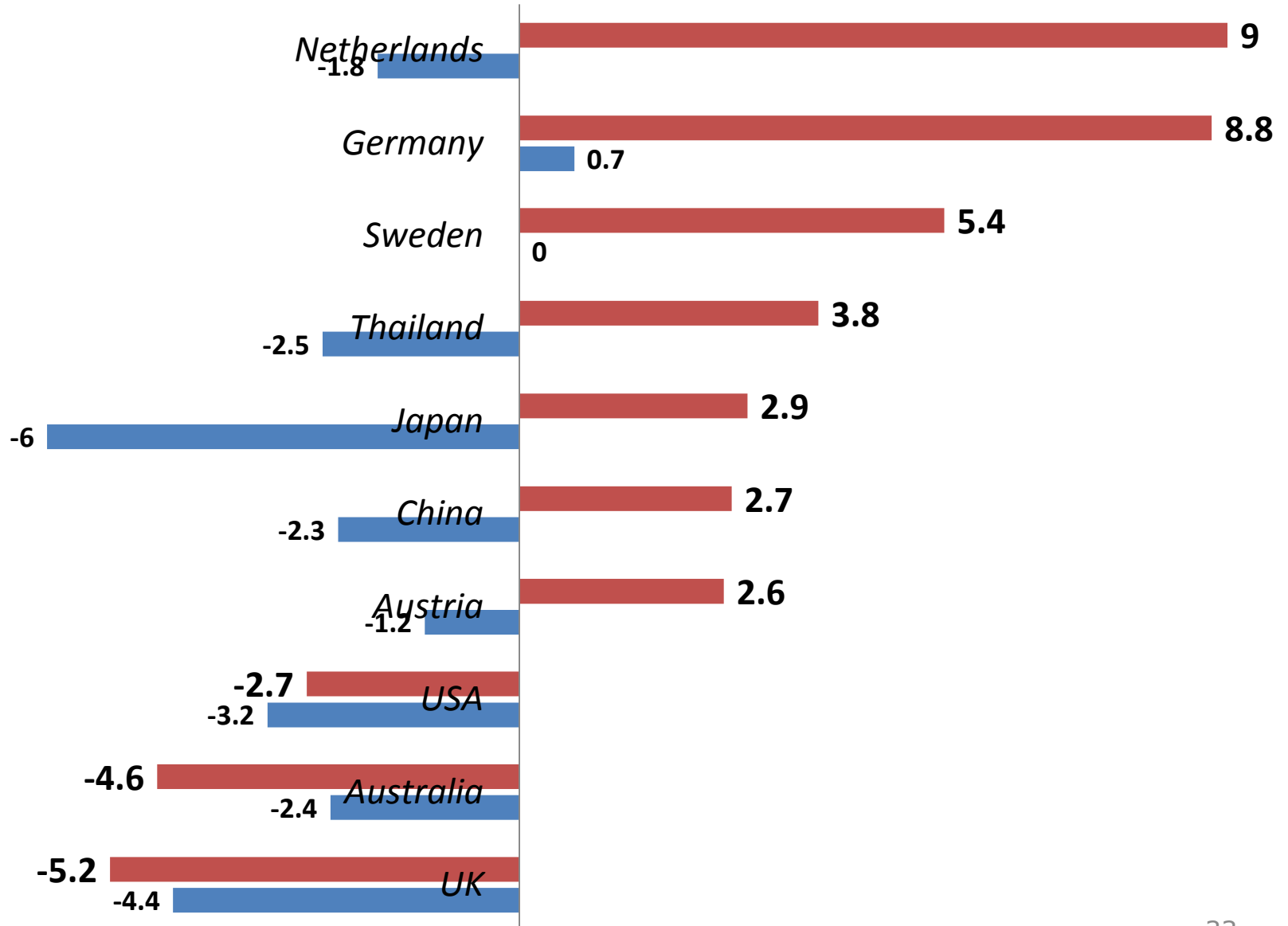
SOURCE: WWW.TRADINGECONOMICS.COM | BANK OF THAILAND

Source: Trading Economics.com

Twin Deficits?

■ Current Account (%GDP)

■ Government Balance (%GDP)



To reduce current account deficit: Absorption must be cut

Domestic Absorption of output (A)

$$A : C + I + G$$

- $M - X = (I - S) + (G - T)$

The twin deficits

- M-X can be thought of as foreign savings used to finance investment gap and budget deficit

- $Y = C + I + G + (X - M) = A + (X - M)$

- $(X - M) = Y - A$

Current account deficit: Absorption (A) approach

- To reduce trade deficit, domestic absorption must be curtailed, if Y cannot be raised.
- The approach ignores the price effect (exchange rate)
- $NX=0$ at the trade balance equilibrium, $X = IM$

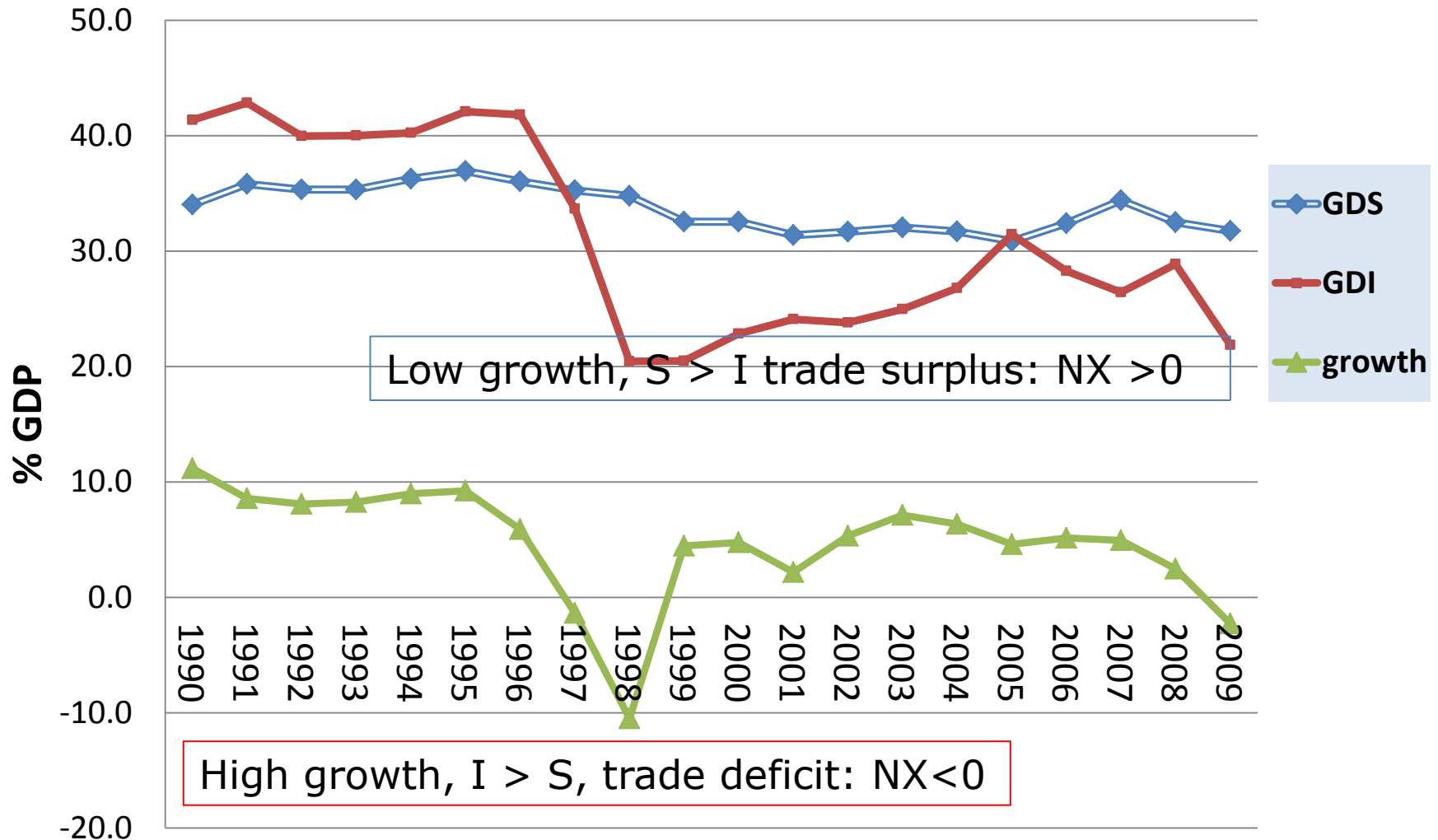
Net Exports: X - IM

$$NX = X\left(Y_f, \frac{eP_f}{P}\right) - IM\left(\frac{eP_f}{P}, Y\right)$$

$$\text{Real exchange rate} = \frac{eP_f}{P}$$

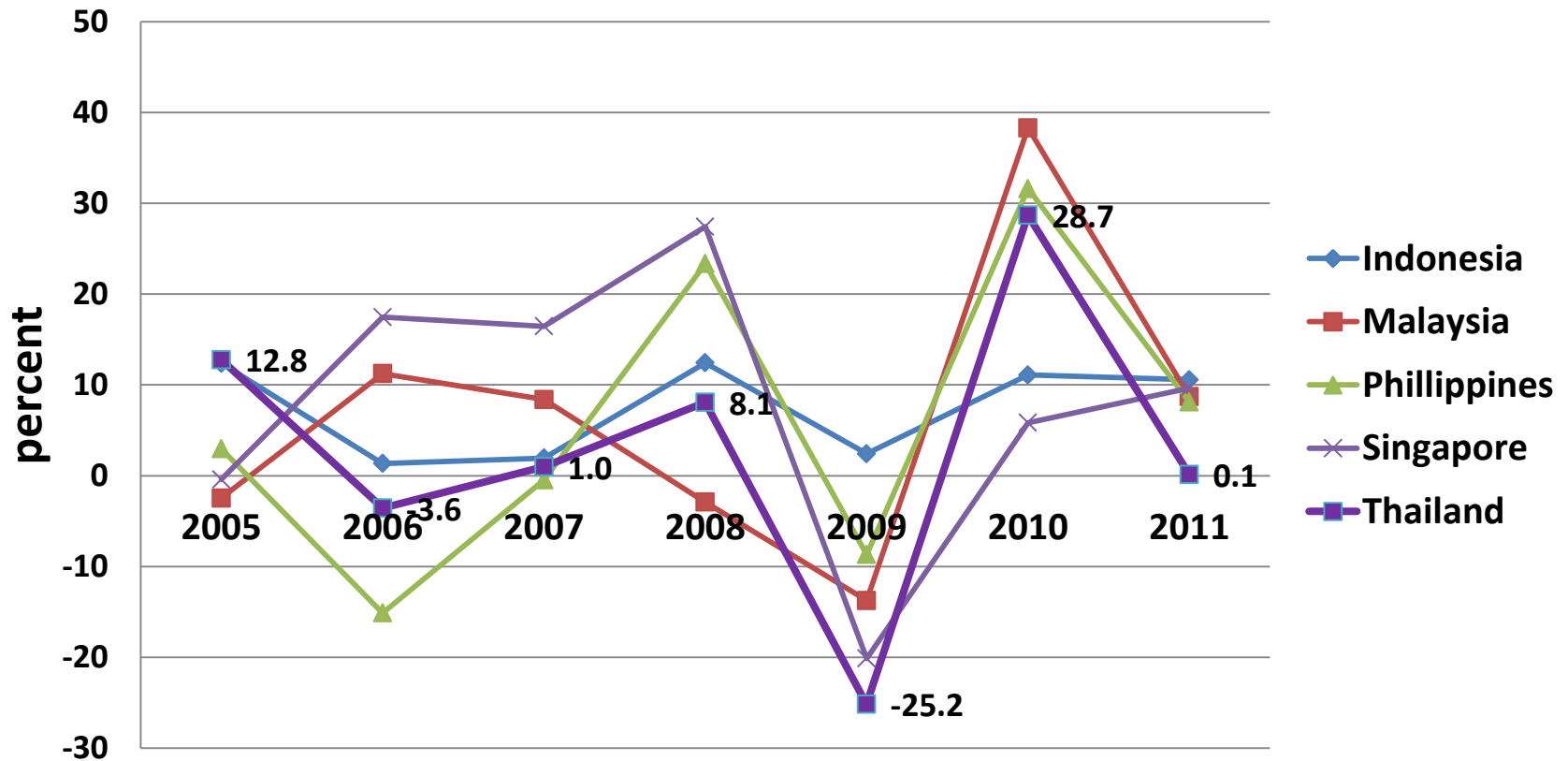
$$e = \text{Baht} / \$$$

Domestic Saving and Domestic Capital Formation: Expansion and Contraction Period of Output



Investment synchronization

Gross Domestic Investment



Investment and growth

- $\Phi = K/Y =$ capital-output ratio (fixed)
- $\Delta K = \Phi \Delta Y$
- $I/Y = \Phi \Delta Y/Y$
- $I/Y = f(g); f' > 0$
- Accelerator effect of growth on investment
- **Faster output expansion gives rise to high investment ratio.**
- But there are also other factors determining investment rate: credit availability, the interest rate, and investor sentiment.

Balance of Payments: Current account (NX) and financial account (CF = net capital inflows)

$$BP = NX \left(Y, \frac{eP_f}{P} \right) + CF \left(i - i_f - \frac{\Delta e}{e} \right)$$

$\frac{\Delta e}{e}$ = expected depreciation

Interest rate differentials: $i - i_f$

BOT Policy rate and FFR

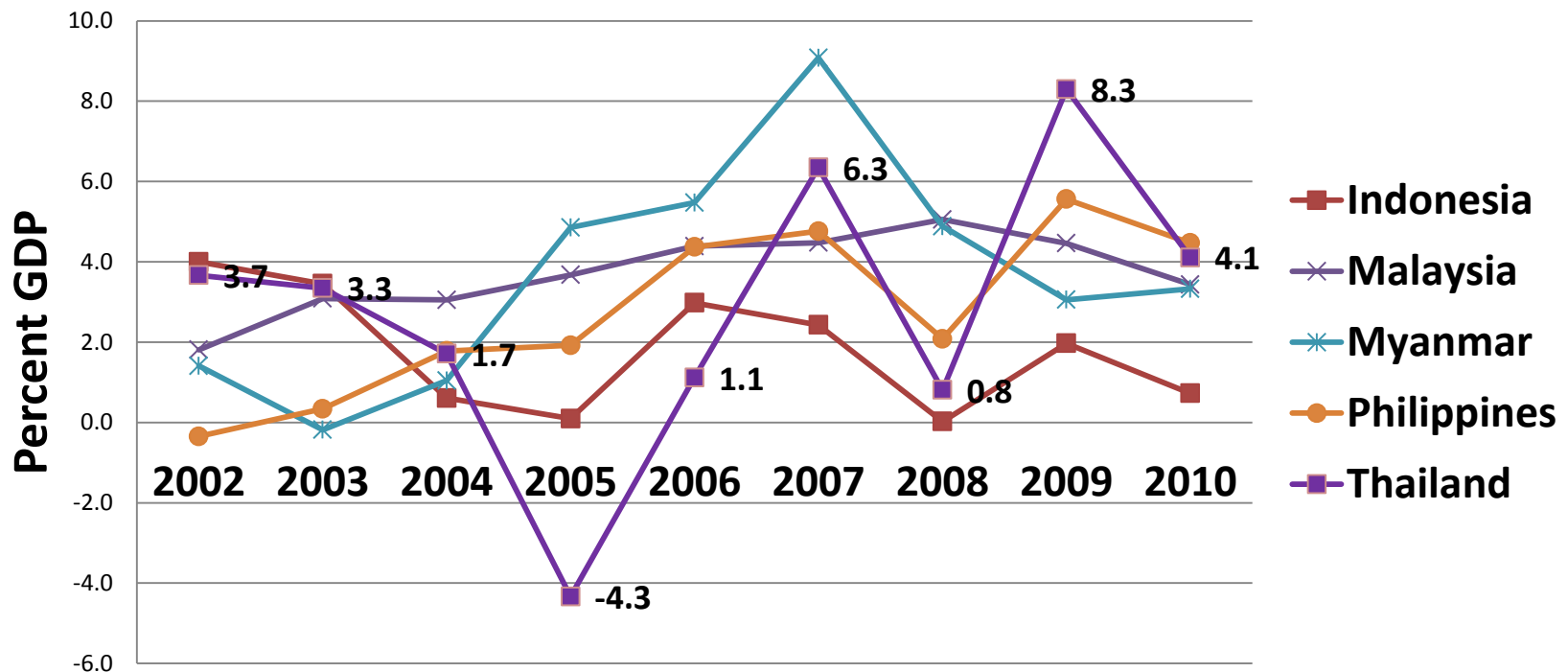


Determinants of current account balances (NX)

- Output growth rate
- Real interest rates
- Capital inflows
- Inflation
- Exchange rates
- Fiscal imbalance
- *These determinants are intricately related.*

What do ASEAN countries have in common?

Current Account



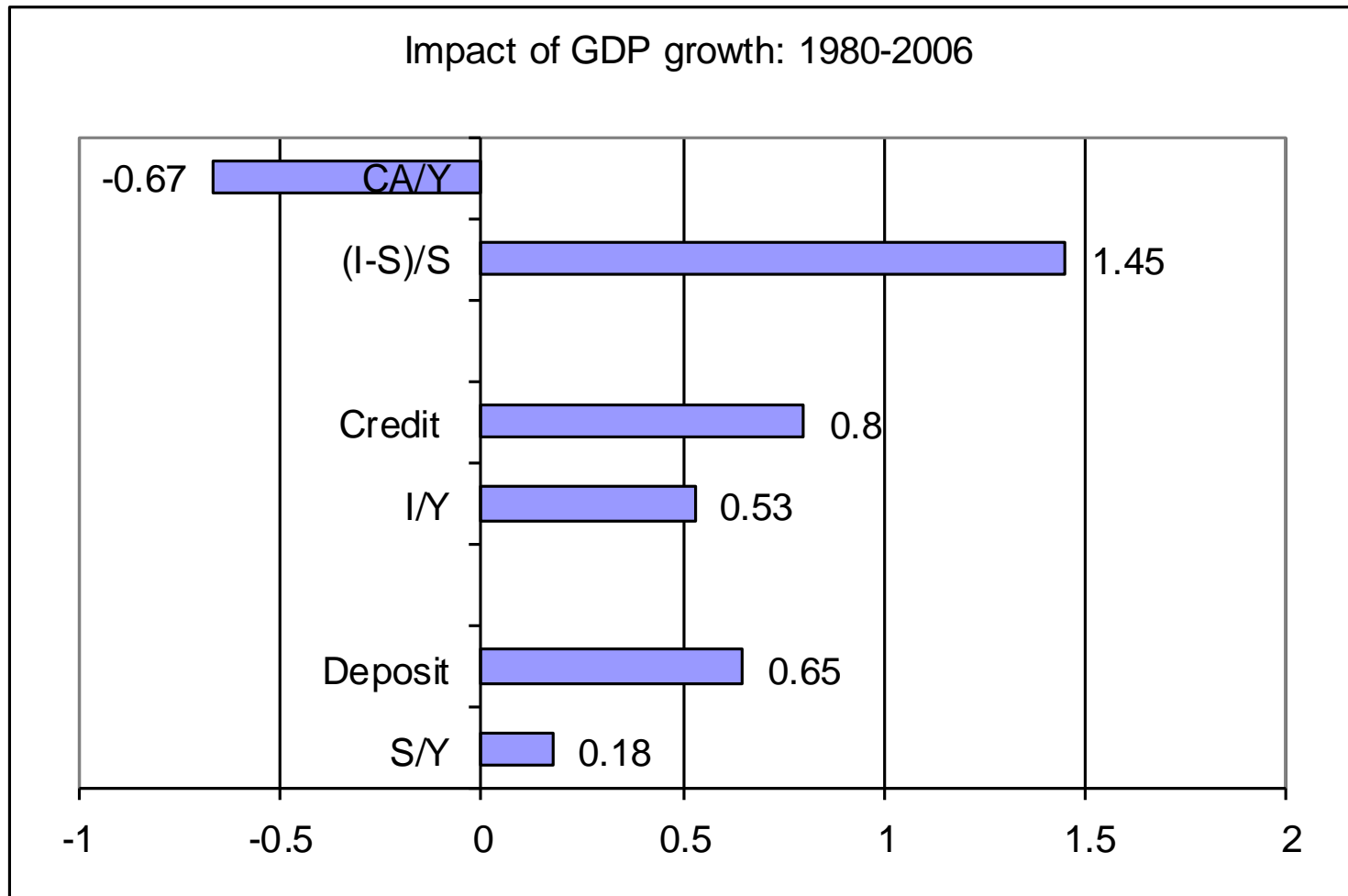
Growth, financial resource, and current account deficit

- Higher expected growth generates demand for credit requires by investors to expand their plants.
- Higher growth increases permanent income and raises saving deposits.
- If loan growth outpaces deposit growth, interest rates tend to rise.

Why does strong growth lead to current account deficit?

- Output growth leads to strong demand for imports of raw materials and capital goods.
- If growth is not export-driven, growth can lead to problem with current account.

When the Thai economy was expanding, current account deficit grows larger, investment-saving gap is wider, credit expands more than bank deposits, investment ratio increases more than saving ratio



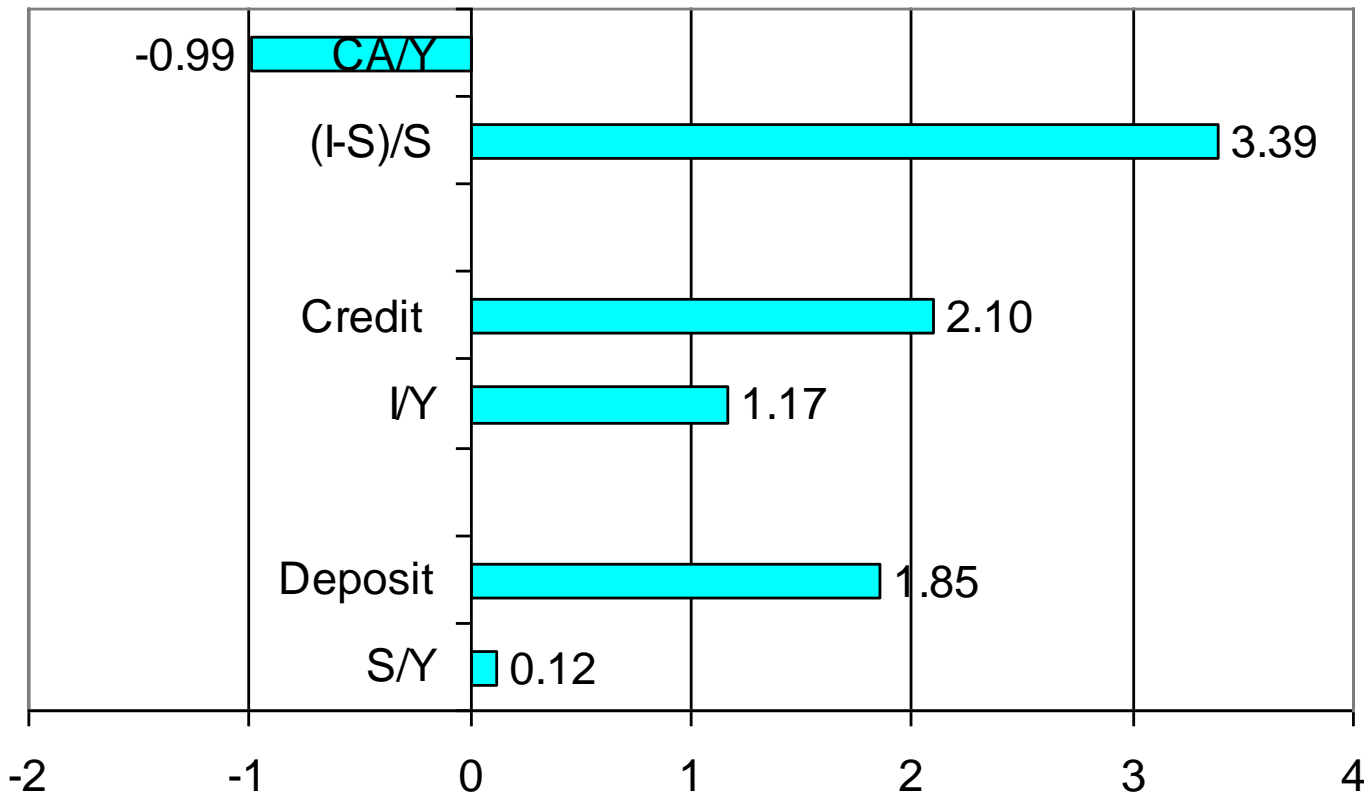
Why strong GDP growth may lead to problems

- Investment rises faster than savings.
- Bank credit grows faster than deposits.
- Investment-savings gap is widening.
- Current account deficit deteriorates.
- However, during economic downturn, we observe surplus in current account.

When the interest rate rises:

Current account deficit increases, investment-saving gap is widened, credit expands faster than bank deposit, investment rises, saving ratio increases marginally compare to investment ratio

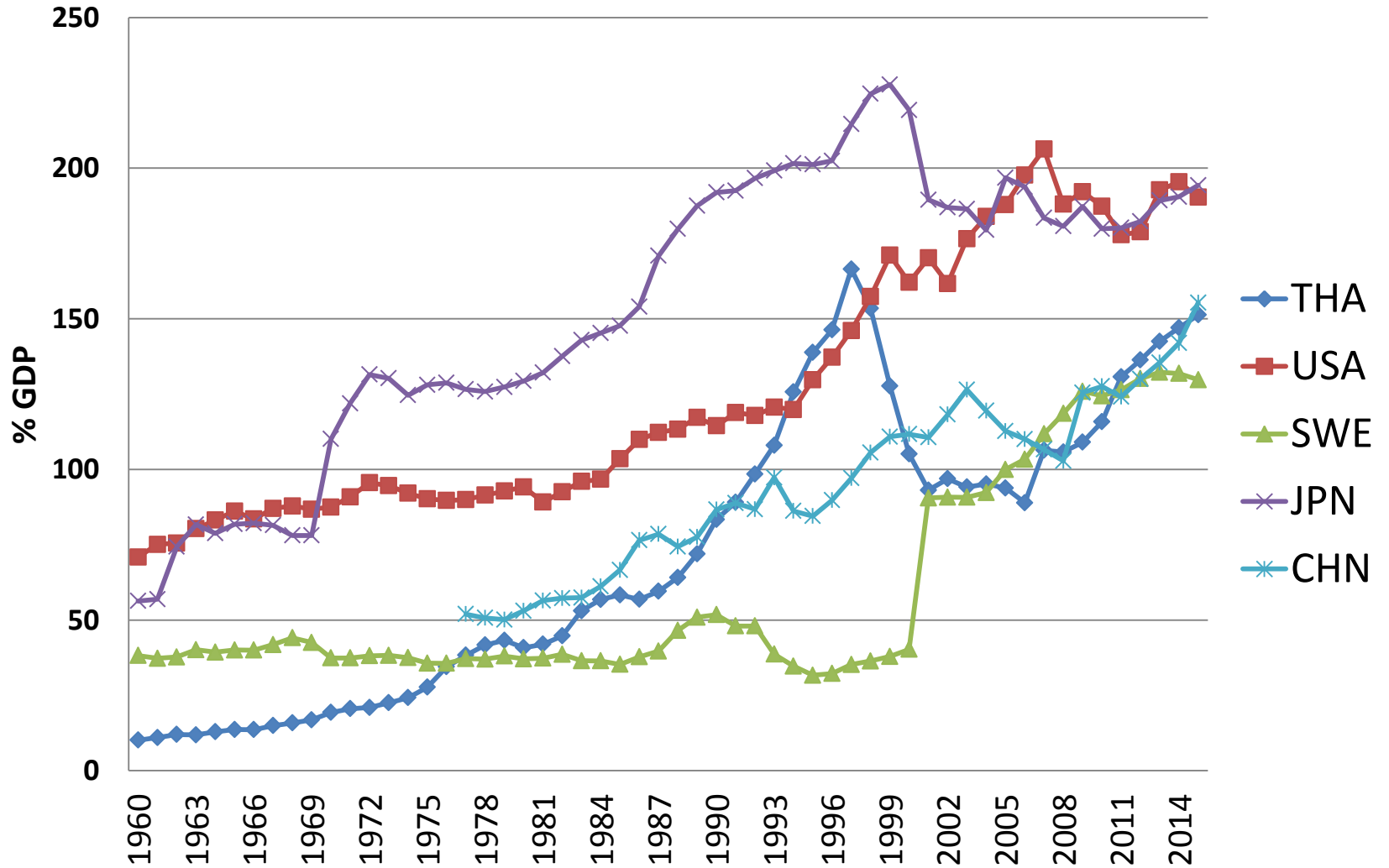
interest rate impact: 1980-2006



As domestic interest rate rises

- Bank credit expands (supply of loan)
- Bank deposit grows
- Bank can borrow from abroad if domestic savings are insufficient.
- Demand for credit should fall, other things being equal.
- With higher expected growth, interest rate rises could lead to widening investment-saving gap.

Domestic Credit to Private Sector



Equilibrating interest rates?

- Similar to growth impacts on current account, interest rates are pro-cyclical.
- Investment-saving gap is widening when interest rate increases, causing external instability.
- With increasing integration, capital flows would mitigate the rise in the domestic interest rates.

A conventional strategy

- Growth is the first priority, in particular export growth.
- Capital inflows propel private investment.
- Exchange rate appreciation was delayed as much as possible.
- Exchange rate competitive (though unrealistic) exchange rates to drive exports.

The role of exchange rates

- There are equilibrating mechanisms, through exchange rate channel, to bring the economy back from imbalances to external balances.
- Exchange rates should be allowed to play the equilibrating role in external balance adjustments.
- Delay the exchange rate adjustments would lead to substantial changes in output and exchange rates in the long run.

Growth engines slowed down

- During period of growth acceleration, private consumption and investment play a leading role.
- During growth slowdown, with the absence of fiscal stimulus, net exports are the **only** growth driver.
- But during the period 2014-2016, with weak consumption and investment demand, unfavorable world trade condition, fiscal policy remain the only option to the Thai government.
- Compared to favorable external markets conditions and competitive exchange rates in 2007, net exports led the recovery in 2007. This is not the case in 2016.

Global rebalancing: China and USA

- When the issue of global rebalancing first emerged, it was focused squarely on the trade imbalance between China and the United States.
- However, the global economic turbulence of 2009-2010, and the subsequent economic fragility and uncertainty enveloping much of the global economy today, has begun to underscore how broad this issue really is.
- China has taken steps to contribute to possible rebalancing. China's currency has appreciated by over 30 percent against the US Dollar since 2005. And it has experienced some decline in its trade surplus in recent years.

China is rebalancing

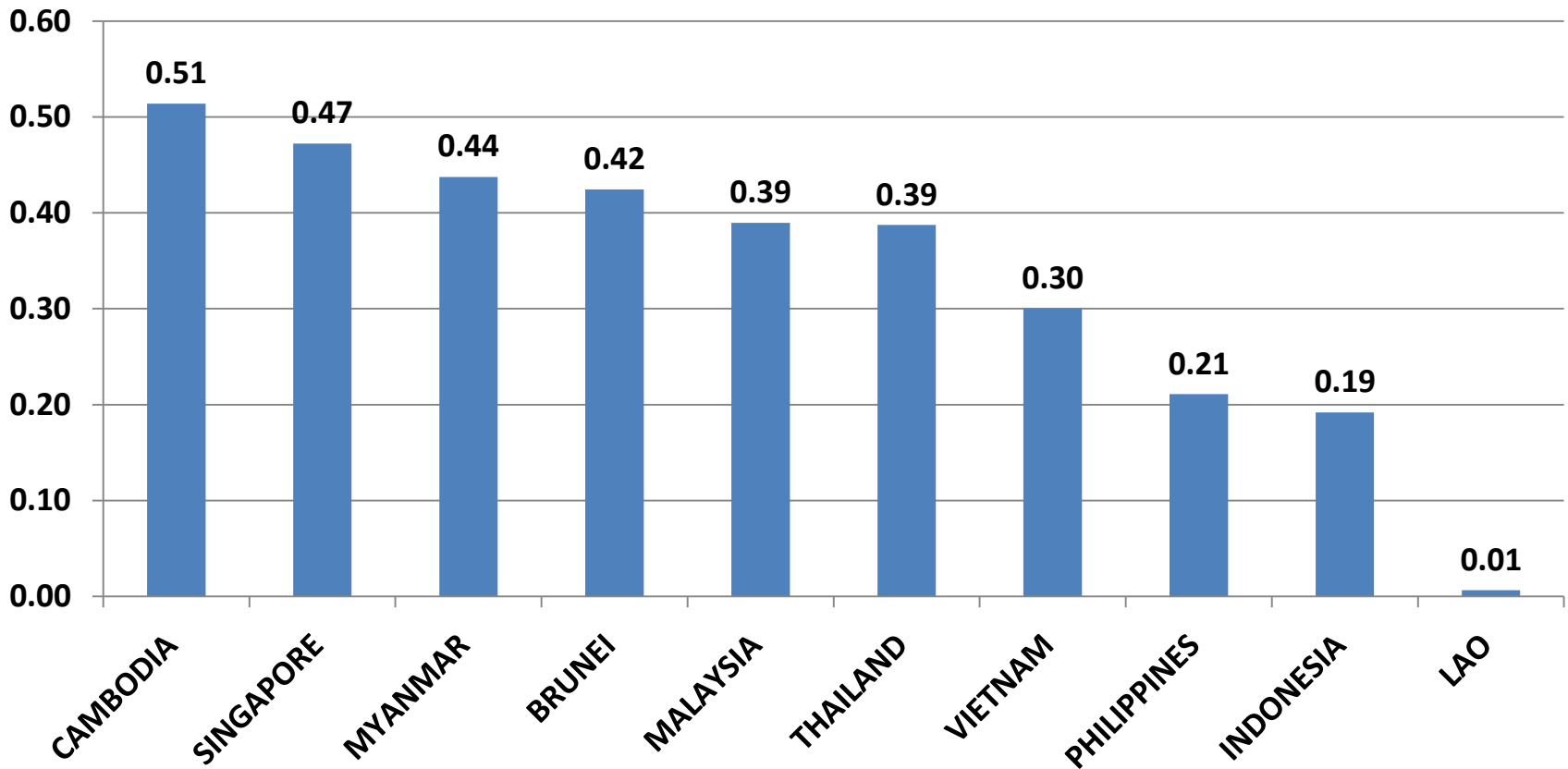
- The consumption share of GDP in China is still low (and even declined according to recent statistics).
- Further, the US still has a current account deficit amounting to about 3.1 percent of GDP. In 2011, the US maintained a trade deficit with at least 91 countries, most of which are in the developing world.
- China needs to consume more or save less, the US must save more and consumer less to reduce China's trade surplus with the US.

China requires structural adjustment

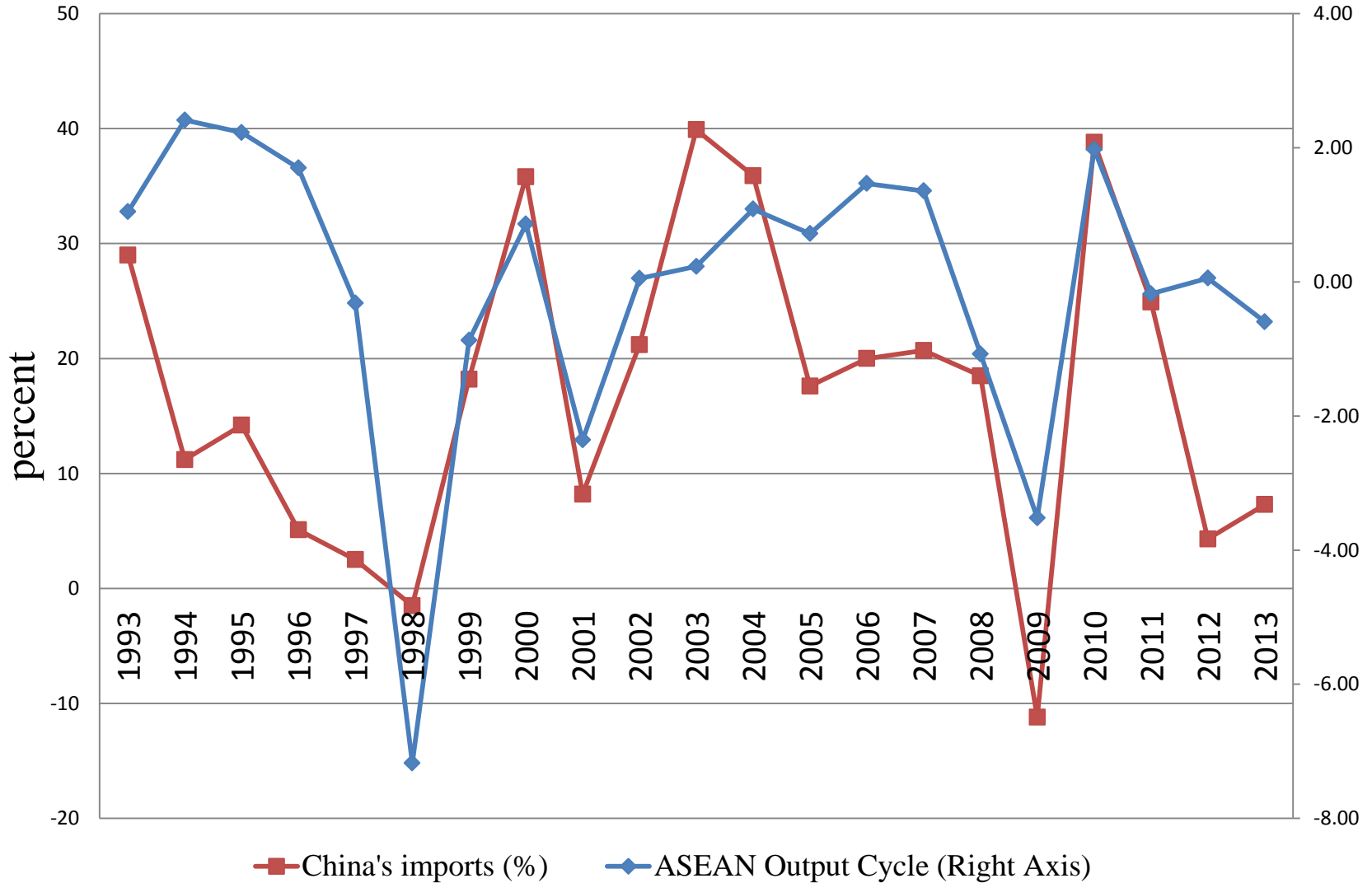
- China will not be able to make a successful transition from investment- to consumer-led growth with an overvalued currency.
- If both investment and exports tank, the surge in unemployment will make reforms difficult to implement.
- But investors are right to worry about a weaker renminbi because it is far from clear that the European Central Bank, the Bank of Japan and the Federal Reserve will quietly accept the necessary changes in relative exchange rates.
- China's FDI outflows and outsourcing: Indonesia and Vietnam

Impacts of China Slowdown

GDP Growth correlation with China's import growth



ASEAN Business Cycle and China's Imports



The ASEAN business cycle and China's slowdown

Bhanupong Nidhiprabha

The economies in the Association of Southeast Asian Nations (ASEAN) have been integrated through increasing trade relations intensified by tariff reductions and increasing openness to foreign direct investment. Rising volume of networks trade has deepened interconnectedness between ASEAN and China, a recent growth locomotive in the world. ASEAN business cycle is shaped by volatile China's trade volume. As China's expansion slows down, adverse consequences on ASEAN economies have become more pronounced. The extent of the damage depends on each member of ASEAN's trade exposure and China dependency. This paper identifies the most vulnerable ASEAN economies to China's business cycle. The slowing down of the Chinese economy would undoubtedly result in a decline in long-term growth of some ASEAN economies, unless appropriate policy responses can be implemented.
