Economic perspectives

Asia edition

October 2020

Highlights

- Recent high frequency indicators suggest that the global economy saw a continuing rebound from the pandemic lows over the summer months. There are signs, however, that economic momentum is losing steam, in particular as the second wave of Covid-19 pandemic is spreading rapidly in Europe and the US. Overall, we maintain a cautious outlook given the significant uncertainty caused by the trajectory of Covid-19, with the risks tilted to the downside on balance.

- China remains on an impressive post-Covid-19 recovery path helped by developments particularly on the manufacturing side of the economy. Q3 GDP data, however, suggests that domestic demand is recovering as well. Given the relative strength of economic data of late and the fact that the pandemic there remains mostly under control, we have revised up Chinese GDP growth to 2.0% in 2020 and 8.2% in 2021.

- Elsewhere in Asia, developments are mixed. Several economies in the region, particularly in East Asia and South East Asia, managed to contain the magnitude of the economic damage caused by the pandemic compared to the global picture, but there are some exceptions (such as Malaysia, the Philippines, and India). Looking forward, the recovery appears to be underway, with most countries seeing a trough in high frequency activity data in April. For many countries, however, the pace of the recovery will be sluggish. The strong recovery in China should, however, help support exports in the region, and containment of the virus in much (but not all) of the region remains relatively successful.

- A stronger-than-expected rebound is also expected for the US, which leads us to upgrade our outlook for annual real GDP growth in 2020 from -5.5% to -4.5%. However, the recovery is losing steam heading into year-end with the expiration of government support measures and additional fiscal stimulus unlikely before the November presidential elections. In addition to coronavirus developments, this represents a major source of uncertainty, in particular stemming from the possibility of a contested election result. This could have negative implications for both the US economy, as well as for financial markets worldwide.

- In the euro area, the recovery that started at the end of the second quarter progressed further during the third quarter, leading to an upgraded view on Q3. However, the near-term growth profile (Q4 2020 and Q1 2021) has become more cautious on the back of the virus's resurgence. Consequently, we updated our growth forecasts for the euro area as well as for individual European economies with, generally speaking, slightly higher growth for 2020 and slightly lower growth for 2021.

- Meanwhile, Brexit negotiations are heading to a critical point. We maintain our longstanding view that a limited trade deal between the UK and the EU can be concluded by the end of this year. Even if such mini-deal is far from perfect, avoiding the cliff scenario of a no-deal Brexit would be the best outcome in order to avoid a further slowdown in the recovery pace. The recently signed formal trade agreement between the UK and Japan, for the most part, mirrors the EU-Japanese agreement in place.

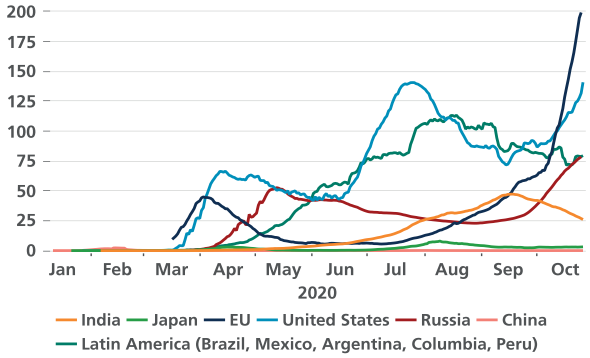
- Our oil price outlook was revised downward on demand weakness and rebalancing of the market taking longer to unwind the supply glut than initially expected. Against this backdrop, as well as due to the continued disinflationary impact from the pandemic, inflation is expected to remain low, though disinflationary pressures are notably less pronounced in the US than in the euro area. India is also experiencing some upward inflation pressure due to supply-side disruptions from the pandemic.

Global economy

Over the summer months, the global economy saw a continuing recovery from the lows of the first half of the year when the Covid-19 pandemic emerged. Data releases across the major advanced economies were relatively upbeat with some upside surprises, implying a somewhat stronger bounce back from the economic damage caused by the spring lockdowns than expected in our last edition. These positive developments reflect first and foremost gains from opening up economies, supported by massive policy actions, both on the fiscal and monetary front. Therefore, it should come as a no surprise that the upcoming third-quarter real GDP figures will show impressive growth dynamics (on a quarter-on-quarter basis). Both the euro area and the US are set to follow the general growth pattern of China, a global frontrunner in terms of the post-lockdown recovery. Emerging markets, meanwhile, have seen mixed developments, with some economies bouncing back quicker than others.

At the same time, upcoming Q3 real GDP readings should be treated with caution. Indeed, the figures will provide merely a glance in the rearview mirror. As such, a strong rebound was essentially mechanical, reflecting the one-off boost from economies opening up, meaning that the pace is not sustainable going forward. We have already seen this in China, where the quarter-over-quarter pace of GDP growth normalized from 11.7% in Q2 to 2.7% in Q3.

Figure 1 - Covid-19 Pandemic: Confirmed Cases
new cases, 7-day periods, per 100.000 inhabitants



Source: KBC Economics based on WHO, Eurostat, UNDESA

Additionally, notwithstanding the bounce-back, most economies have so far seen only a partial recovery in many sectors, with activity well below the pre-pandemic level. After the low-hanging fruit was picked, full normalisation of economic activity thus appears more difficult. Furthermore, the forward-looking sentiment indicators in certain advanced economies already signal that underlying momentum is losing steam going into the final quarter of the year.

The second Covid-19 wave

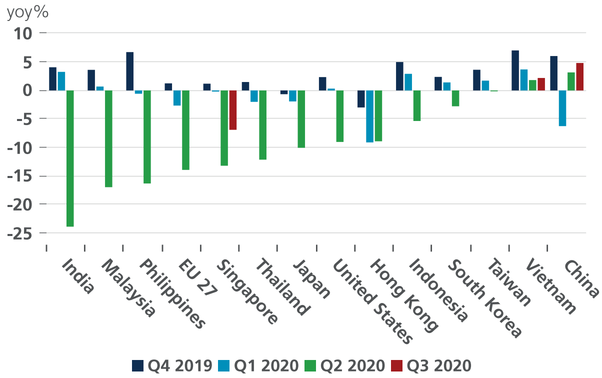
The most prominent headwind for the pace of the recovery remains the situation on the epidemiological front and the subsequent policy reaction to it. Worldwide, the number of confirmed Covid-19 cases has now passed 37 million and a death toll of more than 1 million. With the exception of several East Asian and Southeast Asian countries, the second wave of the virus has been spreading fast across the globe, not least in Europe which has seen a rapid resurgence of the virus (figure 1). In many European countries the number of new daily cases has surged above the level recorded in March and April, bearing in mind that comparison is distorted due to the more robust testing capacities now available. In contrast, the death rates remain generally lower than during the first wave of coronavirus.

In Europe at least, we do not see the same policy response as during the first wave. Governments appear reluctant to re-introduce full-blown national lockdowns because of the damaging socio-economic impact. Instead, most are opting for localised lockdowns and targeted restrictive measures to tackle the spread of the virus. In our baseline scenario, we maintain the assumption that the full lockdowns will be avoided; however, given the upcoming winter season in the northern hemisphere when people spend more time indoors, which increases the chances of the transmission, we cannot rule out this possibility.

But even if the spring-like lockdowns are avoided, globally, the presence of the virus continues to have a negative impact on activity, especially in the 'social-consumption' sectors such as hospitality, entertainment or tourism. Given the more limited economic damage we've seen in economies that have managed to keep virus numbers low (such as China, Vietnam and Taiwan), management of the virus will remain an important source of divergence, adding to the differences stemming from economic structures and policy responses. In particular, manufacturing-reliant economies appear more vulnerable than service sector-reliant ones, given the specific nature of the coronavirus crisis.

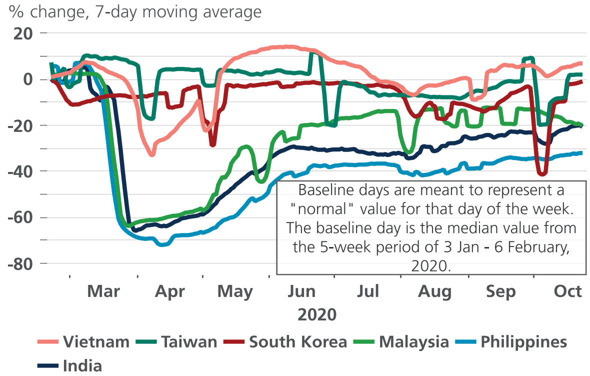
Apart from corona-related risks, there is a full plate of additional downside risks, namely the US November Presidential elections, a no-deal Brexit, the geopolitical clash between the US and China or the most recent conflict in Nagorno-Karabakh, involving regional powers such as Turkey and Russia.

Figure 2 - Real GDP growth



Source: KBC Economics based on national sources

Figure 3 - Workplace mobility compared to baseline



Source: KBC Economics based on Google

Asia Focus

The Covid-19 Pandemic has undoubtedly hit Asian economies hard, with all countries seeing steep drops in GDP growth in either the first or second quarter of the year. The picture on a country-to-country level, however, is mixed. Several economies in the region, particularly in East Asia and South East Asia, managed to contain the magnitude of the economic damage caused by the pandemic compared to the global picture. South Korea's economy only contracted by 2.77% yoy in Q2 while Taiwan's economy only contracted 0.15% yoy. Vietnam even managed to grow 1.82% yoy in Q2, though this still entailed a sharp drop in the pace of GDP growth compared to the end of 2019 (Figure 2). But not all economies in the region were spared from severe economic damage. In the Philippines and Malaysia, real GDP growth contracted 16.32% and 16.96% yoy, respectively. India, meanwhile, recorded one of the steepest drops in GDP of any country, with a contraction of 23.89% yoy.

A comparison of Google mobility statistics for the worst and best performing economies in the region reveals a direct correlation with a decline in the amount of time spent at the workplace and the extent of the economic collapse (Figure 3). This doesn't mean strong measures weren't taken to contain the virus in Vietnam or Taiwan. On the contrary, both Vietnam and Taiwan took early, concrete action, which included testing and tracing, localized lockdowns and quarantines. And indeed, aggregate cases per capita in Vietnam and Taiwan are far lower than aggregate case numbers elsewhere in the region, particularly compared to India.

There are a variety of reasons for these distinctions. As the IMF notes in its latest Regional Economic Outlook for Asia and Pacific, India, Indonesia and the Philippines reopened before infection rates fell sufficiently, leading to a resurgence in cases. Structural factors likely played a role as well, such as population density, the prevalence of migrant workers, and weaker health systems.

Looking forward, the recovery appears to be underway, with most countries seeing a trough in high frequency activity data in April. For many countries, however, the pace of the recovery will be sluggish. Singapore, for example, is one of the few countries that already released Q3 GDP growth. While real GDP did recover compared to the low reached in Q2 (by 8.5% qoq), it was still -6.9% below the level reached one year earlier. This is clearly a slower recovery pace than what was seen in China, where the economy already reached its end-2019 level in the second quarter of 2020. In general, the pace of the recovery will depend on the importance of contact-intensive sectors in a country's economy, the recovery in important trading partners, space for continued fiscal and monetary support, and the trajectory of the virus's spread. Some lower income economies in Asia may see inequalities exacerbated which can weigh on longer-term recovery prospects. For further analysis on long-term trends and changes in Asia, please see a guest contribution from Professor Arnoud De Meyer of Singapore Management University, **Box: The next world as seen from Asia**.

Box - The next world as seen from Asia[1]

The following is a guest contribution by Professor Arnoud De Meyer. Professor De Meyer is a University Professor at the Lee Kong Chian School of Business at Singapore Management University, where he was President from 2010 until the end of 2018. His research areas focus on Manufacturing Strategy, R&D Management and International Management in Asia.

The pandemic struck us by surprise. Perhaps a bit less here in East Asia than in the rest of the world. Indeed, we had the experience of SARS, H1N1 and MERS, and the blueprints for targeted lockdowns, tracking and tracing, and isolating infected people were waiting in the drawer. The uncertainty and scale of this pandemic required nevertheless short-term crisis management. Now the time has come to reflect on the next normal and to plan for investments and new business models for a very different context. We know from previous global crises that they tend to accelerate underlying trends. From my perspective here in Singapore and East Asia I see five major changes.

The first one is the digital substitution. Many commentators write about digitalisation of business models, as if companies can just switch their operations to a digital model. But few seem to realise that in many cases the digital solutions come from newcomers. Traditional retail in our big and glitzy shopping malls is replaced by online shopping. But the new players are called Alibaba, Tencent, Lazada, Shopee, JD.com, and are not the former real estate developers who owned the malls. Fintech and online banking are replacing the traditional financial institutions, but many of our Asian banking groups have difficulties in adapting to this new competition. What we see is more digital substitution with its new winners and losers, with geographical displacement of jobs, and with new skills requirements. And as the recent turmoil around TikTok and WeChat (Tencent) suggest, the source of leading-edge applications isn't exclusively Silicon Valley or some European hi-tech clusters anymore. The sources of leading-edge consumer requirements and information technology is shifting towards Asia, with China and Korea in the lead. All this is going to have major socio-economic consequences on our economies.

We also need a major review of our supply and logistics networks. The pandemic has exposed the fragility of the supply ecosystems for many products including food, medical and PPE, or paper products. This fragility is due to three factors: extensive globalisation of production; the erroneous idea that supply comes through a simple chain or a pipe, rather than through a complex network of players; and the exhaustive use of lean methods, a legacy from the Japanese manufacturing techniques from the eighties. Perhaps we see the end of an era in supply management. Asia needs new paradigms to organise its supply ecosystems on the basis of robustness and customer responsiveness rather than efficiency.

A third trend is the selective decoupling between the USA and China. This is not new. Since China decided in the early 2010s to create its own international collaborative networks and institutions through for example the Belt and Road Initiative (BRI) or the Asian Infrastructure Investment Bank, to diversify its food supplies and to limit the access of US based social media, it had started its own decoupling. The recent actions by the US Administration are just a belated reaction to a China that is going its own way. Our challenge in Asia is how to position ourselves vis a vis these two ecosystems. The disconnection will not be as thorough as the one between the West and the Soviet Bloc during the Cold War. Both the USA and China benefit too much from mutual trade. But for major investment projects in infrastructure, critical digital technology and health care management, there may be two incompatible alternatives. The comparison between the handling of the pandemic in China and East Asia or the USA, or the perceived superiority of technology like WeChat over WhatsApp makes the Chinese alternative quite an attractive one for many countries in this region.

The pandemic will also accelerate the drive to make our economies more sustainable. Let's face it. With some rare exceptions in Japan, Taiwan or Singapore, East Asian countries have been no champions of sustainability initiatives. But President Xi's commitment to the UN that China wants to be carbon neutral before 2060 is resonating with public opinion in the region. The pandemic has prepared a majority of Asians for the fact that drastic action is needed. A concept that is making headway among politicians and leading businesspeople is that of "ecosperity" or the idea that prosperity and sustainability, combined with good governance and stewardship, are not mutually exclusive, but should reinforce one another.

1. This is an external guest contribution and does not necessarily reflect the views of KBC

This leads me to a fifth challenge, and that is the widespread nervousness about the state of global governance. In smaller or less powerful Asian countries there is the fear that global governance, based on effective international institutions and governed by treaties and international law, may well fall apart. After having tried with limited success to get more influence in existing international organisations, China is now creating its own parallel institutions. The US Administration is withdrawing from WHO and is blocking the operations of the WTO. China and Russia are bullying their neighbours without any significant opposition from the other major powers. The UK government is reinterpreting and overruling the agreement it signed with the EU. From the perspective of many smaller and less powerful countries in Asia, these are very worrying evolutions. As Singapore's PM Lee mentioned in his recent speech to the UN, the multinational rules-based system has given smaller countries a voice and a stake in the global commons and it is the only way to tackle effectively shared challenges like the pandemic and climate change. In their economic growth and rise from poverty, East and South East Asian nations have tremendously benefited from this rules-based global order, and if it would fall apart, it may have very negative consequences for our prosperity and wellbeing.

As you may have noticed, I started by writing about the next normal, not the new normal. I did so because I am convinced that there are many more global crises to come. Just looking back at the last 20 years, we faced here in South East Asia the technology bubble bursting in 2001, SARS in 2003, the devastating Tsunami in 2004, the Global Financial Crisis in 2008, the Swine Flu pandemic in 2009, MERS in 2012, or more localised disasters or diseases like the Fukushima nuclear disaster in 2011, the Ebola outbreak in West Africa in 2014, the Zika outbreak in Brazil in 2015, etc. The next crisis is just around the corner. The real challenge for us here in Asia is how to prepare ourselves for that next unknown-unknown.

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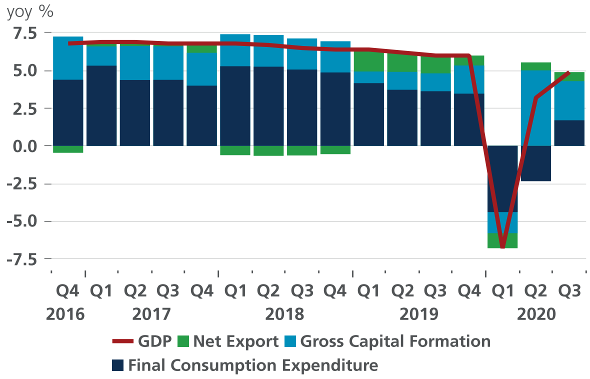
China leads the recovery

China continues its strong recovery, with the economy growing 4.9% yoy in the third quarter. This puts China on track to reach 2.0% annual growth in 2020, making it one of the few economies expected to record positive growth this year. Though the speed of China's bounce back has been notable, this annual growth figure still entails a steep drop in the pace of growth compared to last year (6.1%). So far, China's recovery has reflected a 'two-speed' economy, with higher investment boosting the industrial sector, while consumption and the retail side of the economy lagged behind. The most recent GDP figures, as well as high frequency data on retail sales (3.3% yoy in September), however, suggest that consumer demand in the Chinese economy is indeed recovering. For example, while final consumption contributed negatively to year-over-year GDP growth in Q2, it contributed a positive 1.7 percentage points in Q3. Investment still leads the way, however, contributing 2.6 percentage points to third quarter GDP growth (Figure 4).

Figure 4 - Chinese Real GDP growth and contributions



Source: KBC Economics based on NBS

The relative strength of investment and the industrial sector partly reflects the Chinese authorities' approach to stimulus, which entails relying on state-owned enterprises and local governments to boost infrastructure and investment. While this approach has clearly helped orchestrate a swift recovery following the steep collapse of economic activity in the first quarter, it is not without risks. In particular, already highly indebted local governments and SOEs are seeing their debt ratios rise even further (see KBC Economic Opinion: [China's investment-led growth is a double-edged sword]() for further analysis). Despite these risks, given strong high frequency data of late and the fact that the pandemic there remains mostly under control, we have revised up Chinese GDP growth to 2.0% in 2020 and 8.2% in 2021.

Hong Kong

The past eighteen or so months have been rather taxing on the Hong Kong economy. Hong Kong entered the pandemic in an already weak state due to the social unrest last year, which led to a 1.2% contraction in annual real GDP growth. Like Mainland China, Hong Kong saw the biggest hit to its economy from the pandemic in the first quarter of 2020 (-12% qoq). Unlike China, however, the economy remained exceptionally weak in Q2, contracting another 0.13% compared to Q1 (in other words, stabilization at a very low level). This was led by weakness in private consumption (-14.2% yoy), investment (-21.4% yoy) and exports of services (-46.1% yoy). The latter reflects the suspension of tourism due to border closures. While exports overall will likely be supported by the recovery in China, tourism will continue to be hindered by the pandemic. Furthermore, the third quarter may not have witnessed a particularly strong recovery either. Covid-19 cases rose rapidly in July, leading to new restrictions, while consumer confidence remained fairly weak. Furthermore, ongoing geopolitical developments involving Hong Kong (such as the national security law and reactions from both the US and UK) raise risks for Hong Kong's financial sector.

Japan

Japan saw a contraction in Q2 GDP that puts it at the middle of the pack compared to other advanced economies. With a decline in GDP of 10% yoy in the second quarter, Japan outperformed the EU 27 (-14% yoy) but slightly underperformed the US (-9% yoy). This is despite the fact that Japan was able to keep its number of Covid-19 cases per person well below that of either Europe or the US. Still, a sharp drop in both private consumption and exports led the fall in GDP.

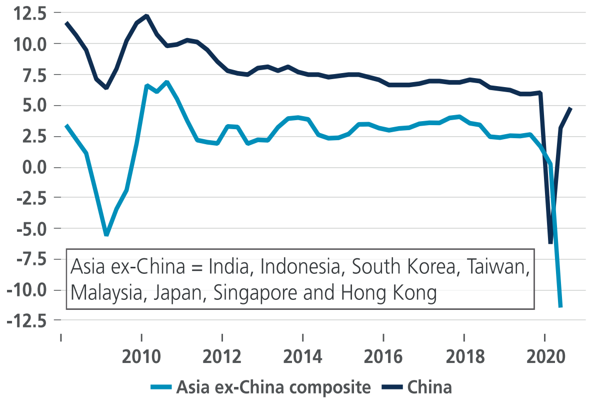
On 16 September 2020, Mr Suga was elected Prime Minister after Mr Abe, who led the government since 2012 and was the architect of the macroeconomic policy called 'Abenomics', stepped down for health reasons. As a close ally and Chief Cabinet Secretary under Mr Abe, Mr Suga is expected to deliver policy continuity in this approach. This consists of ultra-loose monetary policy (in close cooperation with the Bank of Japan), short term fiscal stimulus combined with efforts towards medium term public debt consolidation, and structural labour and product market reforms to boost the potential growth rate of the economy. However, the most important short-term challenge for the new Japanese government is to contain the second wave of the Covid-19 pandemic, which has hit Japan again since August in terms of total number of deaths. The further evolution of the pandemic is the main risk to Japan's economic outlook for 2021.

India's devastating second quarter

India, meanwhile, suffered the largest collapse in real GDP in the second quarter compared to emerging market peers (-23% yoy). While all components fell sharply compared to the first quarter, the particularly dismal growth figure was due to a major collapse in private consumption (contributing -12.99 percentage points). India also faced a particularly strict lockdown which greatly hindered mobility and likely contributed to the sharp fall in consumption. On the positive side, however, the recovery in India does look to be underway. India's sentiment indicator for the manufacturing sector, for example, recovered to 51.6 in September, indicating expansion. Reflecting trends seen elsewhere, services sentiment remains weaker (41.9 in September) but has improved significantly compared to lows reached in June. Passenger vehicle sales have also recovered, growing 24.9% yoy in September, after contracting a massive -89.9% yoy in May, suggesting that domestic consumption is on the rebound. Daily Covid-19 case numbers have also started to stabilize, which will hopefully provide space for the recovery to take hold. The recovery is not yet on fully solid footing, however. Industrial production has not completely recovered (reaching only -8% yoy growth in August). Furthermore, while consumer confidence surveys suggest that views on the future outlook have improved, views on the current outlook declined further in September. Overall, given the dismal Q2 growth figure, we have downgraded Indian GDP growth to -8.4% for FY 2020. In FY 2021, however, we expect a strong (albeit somewhat mechanical) recovery with annual growth at 14%.

Figures

Real GDP growth composite indicators
(yoy %, GDP-weighted)

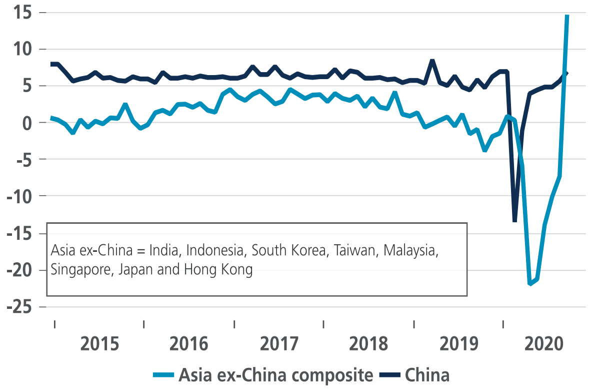


Source: KBC Economics based on national authorities

Manufacturing* PMIs, composite indicators
GDP-weighted

Source: KBC Economics based on IHS Markit
Singapore and Hong Kong = Markit composite indices

Industrial production composite indicators
yoy %, GDP-weighted

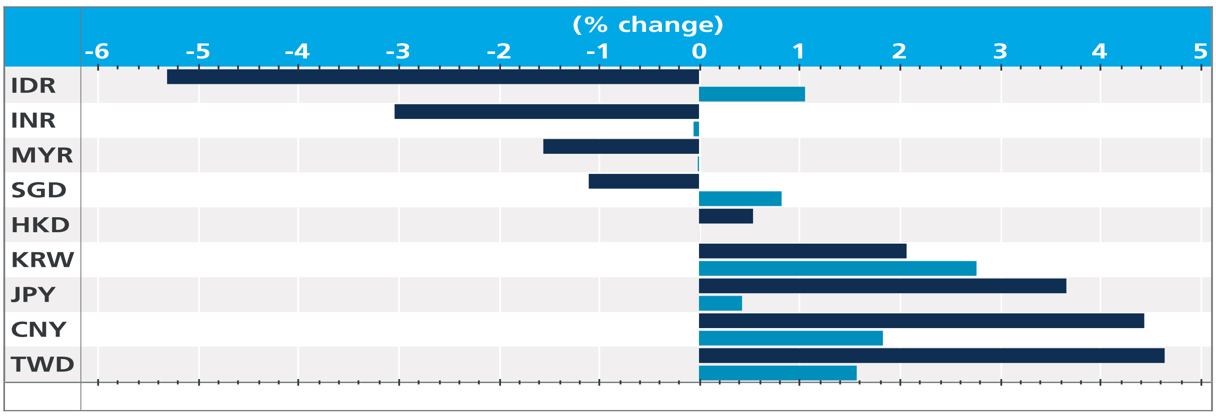


Source: KBC Economics based on national authorities
*latest figure for Asia ex-China only reflects partial results

Retail trade composite indicators
yoy %, GDP-weighted

Source: KBC Economics based on national authorities
*latest figure for Asia ex-China only reflects partial results

Exchange rates vs USD



as of 10/26/2020

■ YTD ■ 1 month back

Source: KBC Economics based on MSCI

Outlook main economies in the world

	Real GDP growth (period average, in %)			Inflation (period average, in %)		
	2019	2020	2021	2019	2020	2021
US	2.2	-4.5	4.0	1.9	1.1	1.9
Euro area	1.3	-8.0	4.9	1.2	0.3	1.1
UK	1.5	-9.5	6.0	1.8	0.8	2.5
China	6.1	2.0	8.2	2.9	2.5	2.4
Hong Kong	-1.2	-7.5	3.7	2.9	0.3	2.4
India*	4.2	-8.4	14.0	4.8	5.5	4.5
Indonesia	5.0	-1.5	6.1	2.8	2.1	1.6
Japan	0.7	-5.6	2.6	0.6	-0.1	0.1
Malaysia	4.3	-6.0	7.8	0.7	-1.1	2.4
Taiwan	2.7	0.0	3.2	0.5	-0.1	1.0
Singapore	0.7	-6.0	5.0	0.6	-0.4	0.3
South Korea	2.0	-1.9	2.9	0.4	0.5	0.9

*Real GDP growth measured over fiscal year from April-March
Source: Forecasts for euro area, US, China, India and Japan are KBC Economic's own forecasts. All others are latest IMF WEO figures.

26/10/2020

Policy rates (end of period, in %)	13-Oct-20	Q4 2020	Q1 2021	Q2 2021	Q3 2021
United States	0.13	0.13	0.13	0.13	0.13
Euro area (refi rate)	0.00	0.00	0.00	0.00	0.00
Euro area (depo rate)	-0.50	-0.50	-0.50	-0.50	-0.50
United Kingdom	0.10	0.10	0.10	0.10	0.10
China (MLF)	2.95	2.95	2.95	2.95	2.95
Japan	-0.10	-0.10	-0.10	-0.10	-0.10
India	4.00	4.00	4.00	4.00	4.00

10 year government bond yields (end of period, in %)	13-Oct-20	Q4 2020	Q1 2021	Q2 2021	Q3 2021
United States	0.76	0.80	0.80	0.80	0.90
Germany	-0.55	-0.30	-0.30	-0.30	-0.25
United Kingdom	0.28	0.40	0.40	0.40	0.50
China	3.18	3.20	3.15	3.15	3.10
Japan	0.03	0.00	0.00	0.00	0.00
India	5.85	6.05	5.95	5.90	5.90

Exchange rates (end of period)	13-Oct-20	Q4 2020	Q1 2021	Q2 2021	Q3 2021
USD per EUR	1.18	1.21	1.22	1.23	1.24
USD per GBP	1.30	1.34	1.36	1.35	1.36
JPY per USD	105.45	106.00	106.00	106.00	105.00
RMB per USD	6.73	6.75	6.75	6.75	6.75
INR per USD	73.27	73.25	73.25	73.25	73.25

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