Economic perspectives
Asia edition

July 2022

Highlights

- The Russia-Ukraine war continues to destabilise the global economy particularly via the commodities channel. Though recession concerns are weighing somewhat on global oil prices, the EU's decision to ban Russian seaborne oil, together with growing concerns about a potential shut off of gas flow from Russia to the EU mean that energy markets remain very tight, and prices are likely to remain elevated. Food prices, while easing somewhat, also remain extremely elevated as millions of tons of grain are stuck in the port of Odessa among other developments (e.g., elevated energy and fertilizer prices, adverse weather events, and pandemic-related disruptions).

- High commodity prices have exacerbated the inflationary shock caused by supply chain issues, heavy fiscal stimulus and the rapid reopening following the COVID pandemic. Headline inflation continues to surge upward across the globe. June headline inflation stood at 8.6% yoy in the euro area and 9.1% yoy in the US. China continues to buck the trend, with headline inflation only increasing marginally to 2.5% yoy in June on higher fuel prices while core inflation remains remarkably subdued. However, elsewhere in Asia, particularly in emerging economies, inflation is also being pushed up by higher fuel and food prices, threatening stagflationary dynamics in the region.

- Inflationary pressures along with tight labor markets have increased the pressure on advanced economy central banks to step up the pace of monetary policy normalisation. In June, the Fed raised its policy rates by 75 bps to the range of 1.5%-1.75% and started phasing in its quantitative tightening. Barring an outright Russian gas embargo, we expect the Fed funds rate to peak at 3.75%-4% in Q1 2023. We expect the ECB to increase its three policy rates by 25 bps in July and to eventually bring the deposit rate to 2.50% at the end of 2023. It also stopped net bond purchases, though it has committed to reinvest maturing bonds with flexibility in terms of timing and markets in order to prevent excessive divergence in euro area bond spreads. Central banks of smaller economies, particularly emerging markets, are also feeling the pressure to raise interest rates further given the combination of faster expected Fed tightening, rising inflation, and a strong dollar. Again, the PBoC is the outlier, as it appears set to keep policy steady, with only marginal, targeted easing measures to support economic growth in the coming quarters.

- The combination of higher, more persistent inflation along with tighter monetary policy will provide a hit to global growth. Higher inflation erodes savings and reduces purchasing power, as real wage growth remains negative and negative wealth effects arise. Meanwhile higher real interest rates and elevated uncertainty drive up (precautionary) savings while discouraging investments and consumption. Consequently, we expect subdued growth dynamics (well below potential) in H2 2022 and 2023 in advanced economies and emerging markets alike. In H2 2022, some cushion may be provided by an expected rebound in China, but risks to the downside remain.

- The tide finally appears to be turning in China with promising signals of a recovery coming through in new data releases. The recovery should continue throughout the second half of the year but will likely not be enough to reach the official growth target of 5.5% for 2022. Challenges remain, including weakness in the real estate sector and the still present threat of further strict lockdowns in the future. We therefore forecast growth of 3.7% in 2022 before a rebound to 5.3% in 2023.

Global economy

A global economy facing a wide range of challenges

The world economy has entered the summer months mired in uncertainty. In the West, ever more persistent inflation is eroding consumer confidence while challenging existing policies of governments and central banks. The latter face an increasingly delicate balance between battling inflation and staving off a recession. China is likely to see a recovery throughout the second half of the year, but still faces its own set of challenges as its real estate market is wobbly and the government has not yet abandoned its zero-covid policy approach. Though it has loosened Covid restrictions in major cities in recent weeks, future lockdowns are still plausible given the high transmissibility of new Omicron variants and the low vaccination rate of its elderly population. Last but not least, there is no end in sight for the atrocities in Ukraine. As the chances of a peace agreement are very slim, the war will likely drag on for the foreseeable future. We maintain as a baseline scenario that the war enters a new stage moving into a frozen (longer-lasting) conflict while Western sanctions will be maintained.

Oil prices: the end of lower-for-longer

With Russia being a commodity powerhouse, the war in Ukraine and related sanctions are clearly reflected in tighter commodity markets and structurally higher commodity prices, which increase inflation and lower economic growth. Prior to the war, oil markets were already extremely tight as loose fiscal and monetary policy along with a rapid reopening of the global economy led to excess demand against the backdrop of supply constraints (by OPEC+) and a general underinvestment in production capacity. The Russian invasion and the strict Western sanctions caused Brent oil prices to surge to new levels, averaging roughly 110 USD per barrel from March through mid-July this year. More recently, financial markets are increasingly pricing in recession risks, leading to some downward pressure on commodity prices.

The EU’s decision to ban all sea-borne oil imports from Russia, along with eventual bans of pipeline imports in member states such as Poland and Germany will affect 90% of Russian oil exports to the EU. Though we assume Russia will be able to redirect part of its exports to Asia at large discounts, we still expect a permanent reduction of Russian oil production of approximately 1.5 mbd. We therefore continue to expect a tight market, despite the recent fall in oil prices due to recession concerns, as OPEC+ is set to maintain a relatively cautious approach amid limited spare capacity, infrastructure constraints and political instability, and as US shale oil producers remain significantly less responsive to higher oil prices due to stricter capital discipline (‘black premium’) and higher ESG/energy transition costs (‘green premium’).

Meanwhile, a reduction in Russian gas flows via the Nord Stream pipeline over the past few months, cumulating in a complete halt of flows due to the start of 10-days of planned pipeline maintenance have raised fears of an imminent Russian gas cut-off. This would significantly impair the ability of EU countries to fill storage levels ahead of the coming winter and is a significant downside risk to our outlook. Such a disruption would be felt most severely in Europe but would also have spill over effects globally.

Inflation is increasingly broad-based and entrenched

Rising commodity prices are furthering inflationary pressures. Inflation prints continue to surprise on the upside in both advanced and emerging economies. Moreover, inflation is becoming increasingly broad-based and entrenched as energy inflation persists, firms continue to use their pricing power to pass-through increasing costs to final consumer prices and tightening labour markets and increasing inflation expectations push wages up.

Food markets are also experiencing a perfect storm as global food prices are up 23% yoy according to the FAO in June (figure 1). Even before the war broke out, climate events put upward pressure on food prices as extreme temperatures in India and low rainfall in France and the US led to poor grain harvests. The Russian-Ukraine war worsened the market balance even further, as both Ukraine and Russia are major food producers and exporters. 25m tonnes of corn and wheat is trapped in Ukraine as Russia is blockading the port of Odessa. If no solution is found, millions of tons might rot. The food crisis is further exacerbated by export bans by, a.o., India.

Current market tensions are not likely to fully unwind in the near term. Due to sanctions, Russia, the world's largest wheat exporter, has no access to Western pesticides, grains and farming equipment and will likely see its output drop as a result. Ukraine, the world's fifth exporter of wheat, will also suffer from a lack of manpower, fuel and reduced available land as a result of the war. Other countries will struggle to make up the shortfall. Sanctions on Russia and Belarus (a major potash producer) have caused fertilizer prices to skyrocket. Labour shortages might also hinder harvests in the Western world. High food prices are not going to be off the table anytime soon.

Persistent inflation triggers central banks

The higher inflation figures have led to broad-based inflation scares and a tightening of monetary policy by most central banks globally. The Fed accelerated its policy normalisation substantially with a 75-basis point increase in the fed funds rate, the largest rate increase since 1994. The policy rate now stands at 1.5%-1.75%. Barring a Russian gas embargo, we expect similar moves in the coming few meetings raising the policy rate to above what is estimated to be a neutral rate (about 2.5%). Fed Chairman Powell stressed the need to move beyond this neutral level with a policy rate of at least 3% at the end of this year and at least 3.5% next year.

Figure 1 - World Food Price Index

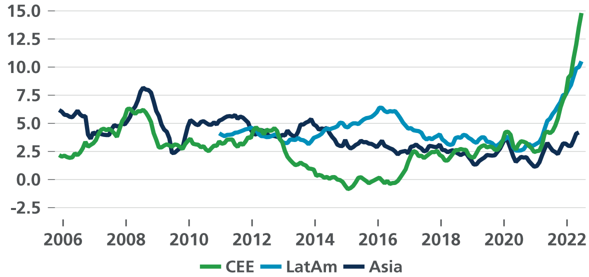
Source: KBC Economics based on FAO

Even the ECB, which had been more dovish, communicated a major shift in monetary policy going forward. At its next policy meeting (21/07) it is set to raise its three policy rates (deposit, refinancing and marginal lending rate) for the first time in more than ten years. ECB President Lagarde announced a 25-basis point rate hike with the intention to accelerate the tightening pace to 50 basis points in September if inflationary pressures persist or worsen. Barring a full Russian gas embargo, we expect the rate hikes in the euro area to continue steadily in October and December (to a deposit rate of 1.25% by the end of 2022). After that, it is expected to be raised to 2.50% by the end of 2023.

As expected, the ECB announced that net bond purchases under the APP will stop at the end of June, and that it will continue to reinvest maturing assets at least until the end of 2024. Moreover, the reinvestments of maturing assets from the PEPP will be done flexibly in terms of timing, markets and asset classes to address any intra-EMU market fragmentation that may occur and jeopardise the transmission of monetary policy. In addition, the ECB announced that it is preparing a new 'anti-fragmentation' programme that will soon be adopted by the Governing Council.

Meanwhile, rising inflationary pressures together with accelerated Fed tightening and a strong dollar put further pressure on emerging market central banks to continue tightening their policy stance. Indeed, many emerging market central banks, already started hiking policy rates last year, particularly in Latin America and Central and Eastern Europe; compared to end-2020, policy rates are 11.25 ppts higher in Brazil, 8.5 ppts higher in Chile, 10.4 ppts higher in Hungary (3-month Bubor), and 6.75 ppts higher in Czechia (as of 12 July). Asian economies, meanwhile, saw a slower start to their hiking cycles and have seen more moderate policy rate increases compared to end-2020 (1.25 ppts in South Korea, 0.9 ppts in India, and 0.5 ppts in Malaysia, for example). The major reason for this divergence has been a more limited level of inflation in the latter economies, particularly compared to CEE or LatAm (figure 2). However, inflation is still on the rise (driven mostly by food and energy prices), and pressure on emerging market currencies given the strength of the US dollar suggests more tightening is on the way, including for emerging Asia.

Figure 2 - CPI by regions
Averages, yoy %



Source: KBC Economics based on national sources
CEE = Czechia, Hungary, Poland
LatAm = Brazil, Chile, Colombia, Mexico
Asia = China, India, Indonesia, South Korea, Malaysia

Asia Focus

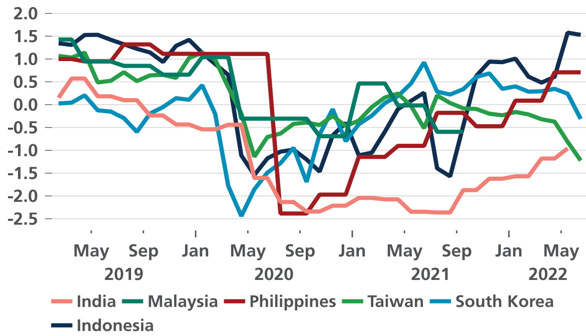
A bumpy road for the region

The global economic landscape has dimmed considerably over the past several months. Like much of the rest of the world, Asia faces a complicated landscape of rising inflation, rising recession risks abroad and volatile financial markets. There are a few bright spots among an otherwise gloomy outlook, however.

First, while growth is likely to slow in the coming months following the global trend, the region may prove to be somewhat resilient. For example, while business sentiment surveys for the manufacturing sectors have been trending down in recent months, for many economies in the region they remain above 50, signaling a continued expansion. Meanwhile, consumer confidence has deteriorated in some economies (e.g., Taiwan, South Korea), but is on the rise in others (figure 3). In addition, while the external environment continues to deteriorate, and trade volumes continue to normalize from the extremely elevated levels of 2021, export volumes from emerging Asia (excluding China) are holding up better than in many other regions (figure 4). On top of that, a recovery in China in the second half of the year, even if the strength of it is held back by ongoing deleveraging efforts and weakness in the real estate sector, will have positive spillover effects for global growth and especially for those in the region that derive a significant share of value added from final demand in China (figure 5 on next page).

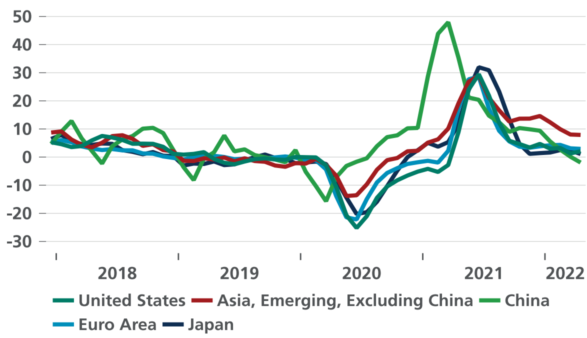
Major economies in the region also appears to be so far more shielded from the financial market volatility that has accompanied the recent repricing of global equity and bond markets. Though benchmark yields (e.g. on 10-year government debt) have generally risen in line with the increase in global interest rates, spreads between 10-year yields in the region and that of the US have mostly trended down throughout 2022,

Figure 3 - Consumer Confidence Indicator
SA, Standardized



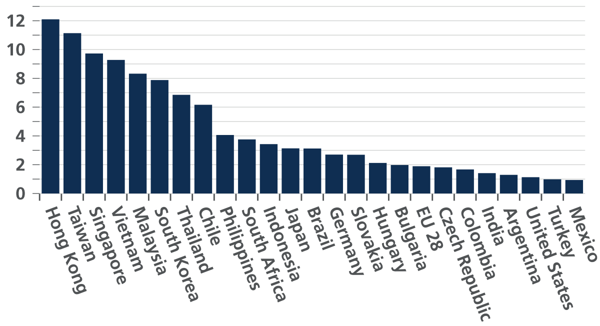
Source: KBC Economics based on national sources

Figure 4 - Export volumes SA
3-month moving average, yoy %



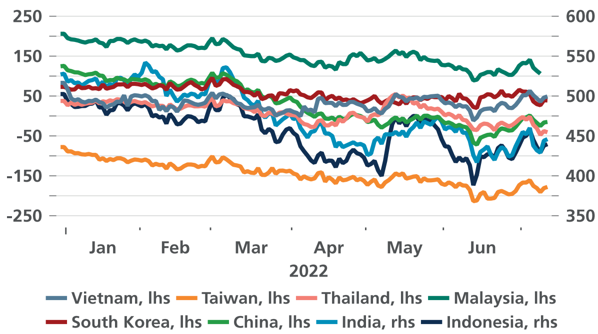
Source: KBC Economics based on CPB

Figure 5 - Value added attributable to Chinese final demand (various countries)
%



Source: KBC Economics based on OECD

Figure 6 - 10 year government yield spreads
spread vs US, bps



Source: KBC Economics based on ANBIMA, Central Bank of Chile, Macrobond, Central Bank

Figure 7 - Emerging market vulnerabilities

	TR	HU	AR	PL	CL	CO	CZ	KR	TH	TW	IN	ZA	MY	CN	ID	VN	MX	BR	RU
Current account balance (4Q rolling, % GDP)*	-3.3	-4.1	0.9	-2.7	-7.4	-6.3	-2.0	4.6	-2.3	15.2	-1.2	3.2	3.1	1.8	0.4	-2.2	-0.2	-1.7	9.2
Fiscal balance (% of GDP, 2022 estimate)	-6.9	-5.4	-3.8	-4.1	-1.5	-4.6	-3.5	-1.6	-6.1	-1.2	-9.9	-5.8	-4.9	-7.7	-4.0	-5.0	-3.2	-7.6	-4.0
Public debt (% of GDP, 2022 estimate)	44	76	74	53	38	61	43	52	63	26	87	70	69	78	43	41	58	92	17
Non-financial corporate debt (% of GDP)*	75	75	18	43	102	33	52	115	89	-	55	33	70	153	25	-	25	54	82
Long term external debt to reserves*	3.0	2.9	4.6	1.9	4.5	0.02	0.5	1.0	0.5	0.03	0.8	2.5	1.4	0.4	2.6	1.2	1.6	0.7	0.6
Short term external debt to reserves*	1.2	0.8	1.8	0.4	0.6	0.01	0.7	0.4	0.3	0.4	0.2	0.5	0.9	0.4	0.4	0.1	0.2	0.2	0.1
3-month average inflation vs. target (yoy)	69.0	7.6	52.9	11.5	8.5	6.3	13.8	3.4	3.5	-	3.3	1.6	-	-0.8	0.8	-1.0	4.8	8.4	12.9
Change vs USD (%) YTD	-23.3	-19.8	-19.5	-16.0	-14.7	-12.2	-10.2	-9.4	-8.0	-7.5	-6.6	-6.1	-6.1	-5.4	-4.9	-2.6	-1.9	2.7	21.2

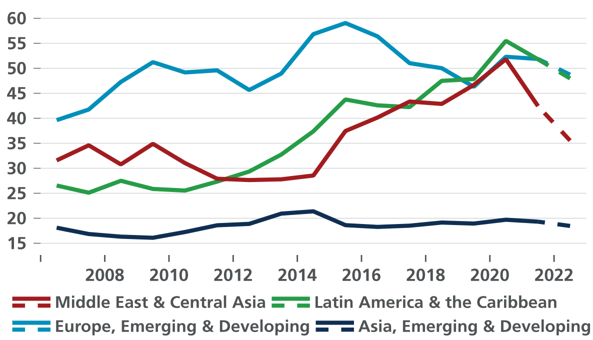
*latest data as of 12 July 2022

Source: KBC Economic Research based on Macrobond, National Authorities, IMF and IIF

suggesting no rising country risk premium is being priced in (figure 6). This likely reflects the fact that most major emerging economies in the region still have current account surpluses (with a few exceptions) and relatively limited external debt versus peers (figures 7 and 8).

This does not mean that the region won't feel any impact from the deteriorating global environment. As mentioned above, inflation is on the rise, including food prices, which have been exacerbated by adverse weather developments in South Asia. An extreme and long-lasting heatwave in India together with a below normal monsoon rainfall has threatened India's wheat crop production, leading to an export ban on the product introduced in May and dashing hopes that India could fill some of the global supply deficit caused by Russia's invasion of

Figure 8 - External Debt
% of GDP



Source: KBC Economics based on IMF

Ukraine (the ban remains in place, though reportedly there may be some exceptions for nearby countries). On top of that, rising interest rates will put pressure on growth in the region, and for certain heavily indebted low-income economies, could lead to growing debt sustainability concerns (as has already been seen with Sri Lanka). Rising interest rates also constrain the ability of governments to provide support measures to help economies weather the current cost-of-living shock. Indeed, while a recent UN report on the global impact on the food, energy and financing shocks caused by the war in Ukraine notes that larger countries in East Asia and the Pacific are not severely exposed, many smaller island states may face severe consequences[1].

China

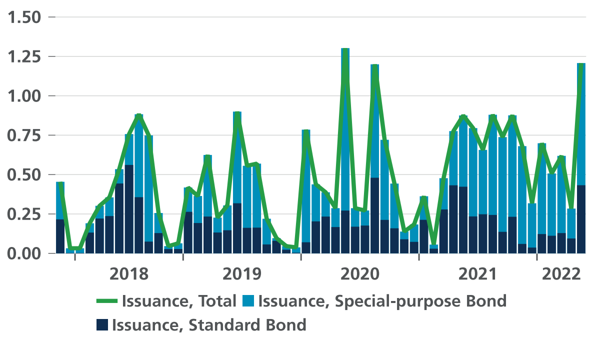
The tide finally appears to be turning in China with promising signals of a recovery coming through in new data releases. Notably, business sentiment survey indicators for both the manufacturing and services sectors rebounded significantly in June after collapsing in March and April (figure 9). This could suggest some room for a relative surprise to the upside in the Q2 GDP figures, which likely registered a sharp contraction in quarter-over-quarter terms. The extent of that contraction (to be released on 15 July) will provide information on how far the authorities are from reaching their official growth target for 2022 (5.5%) and could provide some hint as to the extent of the rebound that can be expected in the current and coming quarter. Even with a strong rebound, we do not expect the annual average growth figure to reach the target, with growth of only 3.7% in 2022 before a rebound in 2023 to 5.3%. However, it is important to note that the Chinese authorities have not abandoned the zero-covid policy that led to the strict lockdowns in the first part of the year. Given the ongoing spread of highly transmissible new Omicron variants, the risk of renewed lockdowns continues to hang over the expected recovery.

Government support for the recovery appears to be coming mainly on the fiscal side in the form of increased local government bond issuance (figure 10). There are also unconfirmed reports that local governments will be permitted to pull forward issuance quotas for next year already to the end of this year. This should help boost infrastructure spending, which has been weighed down by weakness in the real estate and construction sectors (figure 11).

Signs of further support from the monetary policy side appear so far limited. Total liquidity outstanding via the PBoC's various lending facilities has remained relatively stable for the past several months, and though the PBoC lowered the reference rate for five-year mortgages (5-year LPR) in May by 15 basis points to 4.45%, the other reference rates (one-year LPR and MLF rate) have remained unchanged since January. This signals the PBoC is hoping to orchestrate targeted (and limited) easing in a way that will support demand in the housing market while still allowing for a deleveraging of the economy. Such

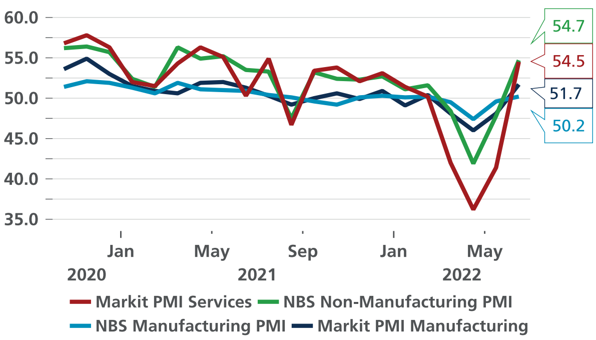
1 UN Brief No. 2, UN Global Crisis Response Group on Food, Energy and Finance, 8 June 2022

Figure 10 - China Local Government Public Debt Issuance
CNY trillion



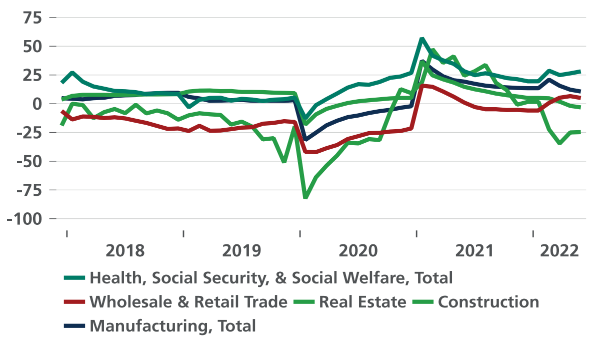
Source: KBC Economics based on MOF

Figure 9 - China PMIs
Index



Source: KBC Economics based on IHS Markit, CFLP

Figure 11 - Fixed Asset Investment
YTD yoy %



Source: KBC Economics based on NBS

deleveraging efforts can be seen in a notable decline in the GDP-to-debt ratio of China's non-financial corporations from 163% in Q3 2020 to 153% as of Q4 2021. Indeed, Total Social Financing growth (a proxy for total credit growth) has been roughly flat throughout 2022, despite the clear signs that the official growth target will be far from achieved this year.

The economy's emergence from the strict lockdowns of the first half of the year have also led to a stabilisation of the yuan against the US dollar after a sharp depreciation between mid-April to mid-May. The yuan is about 5% weaker versus the dollar year-to-date (through mid-July) but has been hovering around 6.7 CNY/USD since early-June. While the move clearly coincided with increased risks to China's economic outlook stemming from the lockdowns, dollar strength and increased interest rate differentials are also major factor in the depreciation year-to-date and one of the main reasons we haven't seen a rebound in the currency despite the reopening. Whereas the Fed is moving at an unprecedented pace to quickly tighten policy (with a 75-basis point rate hike in June likely to be followed by similar-sized moves in the coming meetings), the PBoC has marginally eased policy rates this year and unlikely to tighten any time soon given headwinds to economic growth and the fact that both headline and core inflation remain relatively subdued. We therefore anticipate relative stability in the CNY/USD exchange rate throughout the rest of this year despite the expected recovery in China.

Hong Kong

The covid wave that peaked in early March and led to a sharp contraction in Q1 GDP in Hong Kong (-11.4% q/q saar) subsided by early April, leaving room for a recovery to have likely started in Q2. Sentiment data supports this, with the composite Markit PMI recovering from a low of 42.0 in March to 51.7 in April, 54,9 in May, and 52.4 in June (above 50 signals expansion). Consumer confidence, however, still remains relatively weak, and retail sales declined 4.9% year-over-year in May, suggesting the economy is still struggling to regain its footing. The expected rebound in China throughout the second half of the year, however, should support growth going forward.

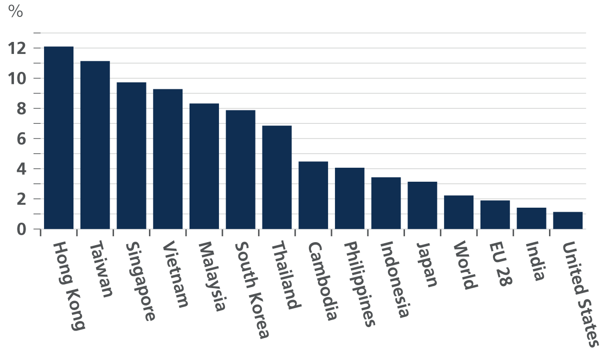
Singapore

Following a slowdown in Q1 2022 from 6.1% yoy to 3.7% yoy (or from 2.3% qoq to 0.7% qoq) due to weaker manufacturing output, the MAS (Monetary Authority of Singapore) Survey of Professional Forecasters for June anticipates economic growth of 4.8% yoy in Q2. Despite this expected acceleration in growth, the economy likely still faced some headwinds in the second quarter. Retail sales growth, which was quite strong at 2.8% yoy in April, decelerated to 0.6% yoy in May, while the shutdowns in China may have still weighed on Singapore's exports in April and May. Though the recovery in China will also support Singapore's trade growth going forward (China is Singapore's largest export partner), reports that excess demand for semiconductors is finally starting to wane could weigh on Singapore's overall export performance going forward (figure 12.

India

Limited data is available yet for the second quarter of 2022, but business sentiment surveys point to continued growth resilience. The services PMI has climbed to 58.7 in June while the manufacturing PMI has remained somewhat stable at a still very strong 54.4. Meanwhile, the Reserve Bank of India's consumer confidence index has continued to improve since September of last year to new highs since the onset of pandemic. Inflation does remain elevated at 7.0% year-over-year in May but is down slightly from the previous peak reached in April (7.8%). However, given the 6% depreciation of the Indian rupee versus the dollar year-to-date (which brings the rupee to an all-time low), pressure has mounted for the RBI to pull forward its hiking cycle. Though the RBI was one of the later emerging market central banks to commence on a hiking cycle (starting in May 2022), the RBI has already increased the repo rate by 90 basis points to 4.9% over two rate hikes. Given the external environment and the growth headwinds posed by the central bank's ongoing tightening, we expect growth to slow to 6.5% in FY 2022 from the 8.7% registered in FY 21.

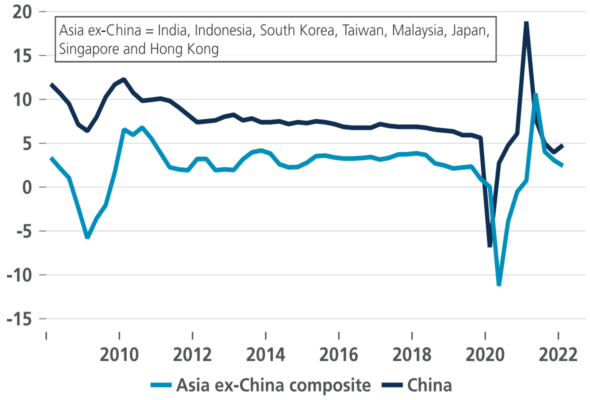
Figure 8 - Value added attributable to Chinese final demand



Source: KBC Economics based on OECD

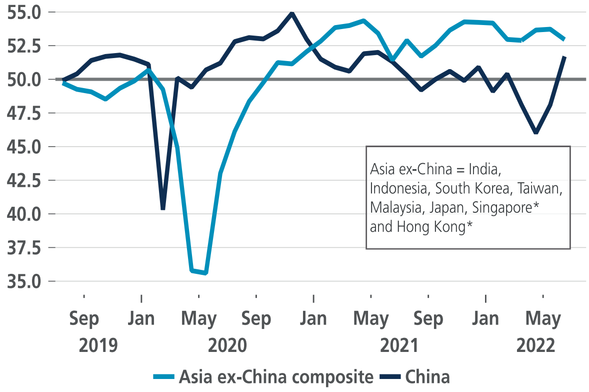
Figures

Real GDP growth composite indicators
yoy %, GDP-weighted



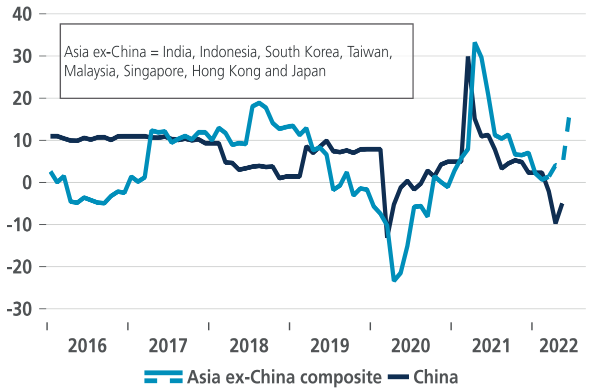
Source: KBC Economics based on national authorities

Manufacturing* PMIs, composite indicators
GDP-weighted



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

Retail trade composite indicators
yoy %, GDP-weighted

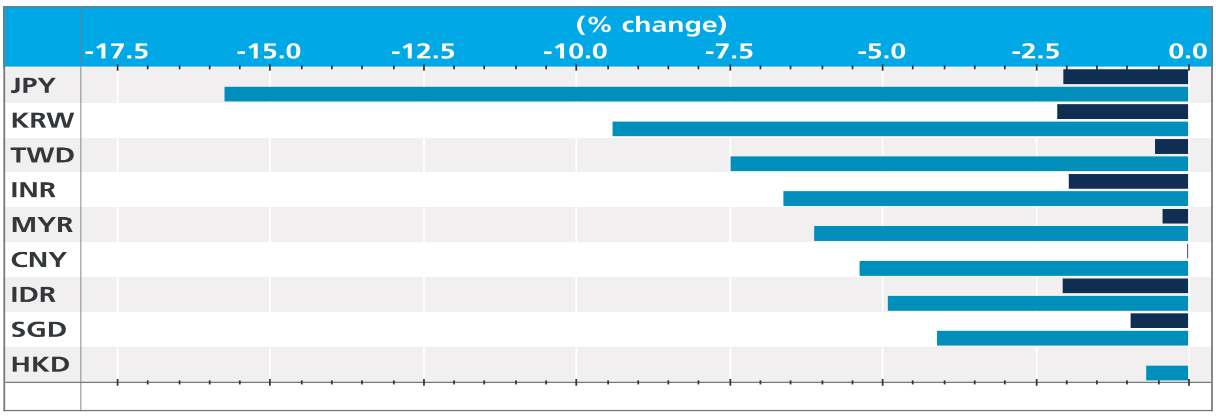


Source: KBC Economics based on national authorities
*latest figure for Asia ex-China only reflects partial results

Industrial production 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 7/13/2022

■ 1 month back ■ YTD

Source: KBC Economics based on MSCI

Outlook main economies in the world

NOTE: Forecasts are those prevailing on 21 June 2022

	Real GDP growth (period average, in %)			Inflation (period average, in %)		
	2021	2022	2023	2021	2022	2023
US	5.7	2.0	1.1	4.7	8.0	3.1
Euro area	5.3	2.3	0.9	2.6	7.5	4.3
UK	7.4	3.5	1.2	2.6	8.3	6.0
China	8.1	3.7	5.3	0.9	2.1	2.3
Hong Kong	6.4	0.5	4.9	1.6	1.9	2.1
India*	8.7	6.5	5.6	5.5	6.8	4.3
Indonesia	3.7	5.4	6.0	1.6	3.3	3.3
Japan	1.7	2.0	1.9	-0.2	1.7	1.1
Malaysia	3.1	5.6	5.5	2.5	3.0	2.4
Taiwan	6.3	3.2	2.9	1.8	2.3	2.2
Singapore	7.6	4.0	2.9	2.3	3.5	2.0
South Korea	4.0	2.5	2.9	2.5	4.0	2.4

*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, prevailing 21 June 2022. All others are latest IMF WEO figures.

21 June 2022

Policy rates (end of period, in %)				
	8-Jul-22	Q3 2022	Q4 2022	Q1 2023
United States	1.63	2.88	3.63	3.88
Euro area (refi rate)	0.00	0.50	1.50	2.25
Euro area (depo rate)	-0.50	0.25	1.25	2.00
United Kingdom	1.25	1.75	2.00	2.25
China	2.85	2.85	2.85	2.85
Japan	-0.10	-0.10	-0.10	-0.10
India	4.90	5.40	5.65	5.90

10 year government bond yields (end of period, in %)				
	8-Jul-22	Q4 2022	Q1 2023	Q2 2023
United States	3.05	3.80	4.10	4.10
Germany	1.30	2.00	2.30	2.60
United Kingdom	2.16	2.80	3.00	3.20
China	2.84	3.40	3.70	3.70
Japan	0.26	0.25	0.25	0.25
India	7.42	8.20	8.60	8.60

Exchange rates (end of period)				
	8-Jul-22	Q4 2022	Q1 2023	Q2 2023
USD per EUR	1.02	1.07	1.10	1.11
USD per GBP	1.20	1.22	1.24	1.25
JPY per USD	136.00	133.00	134.00	135.00
RMB per USD	6.69	6.75	6.75	6.70
INR per USD	79.35	78.00	76.90	76.90

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