

Beyond the Credit Crunch - Has Asia Decoupled?

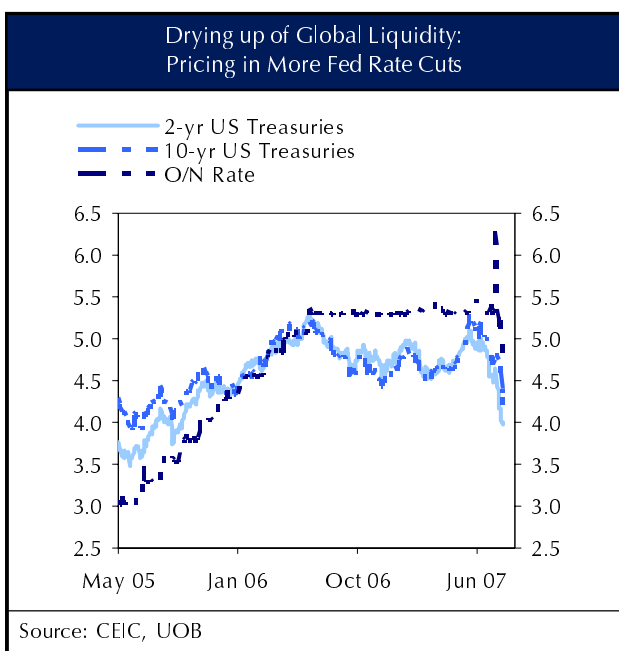
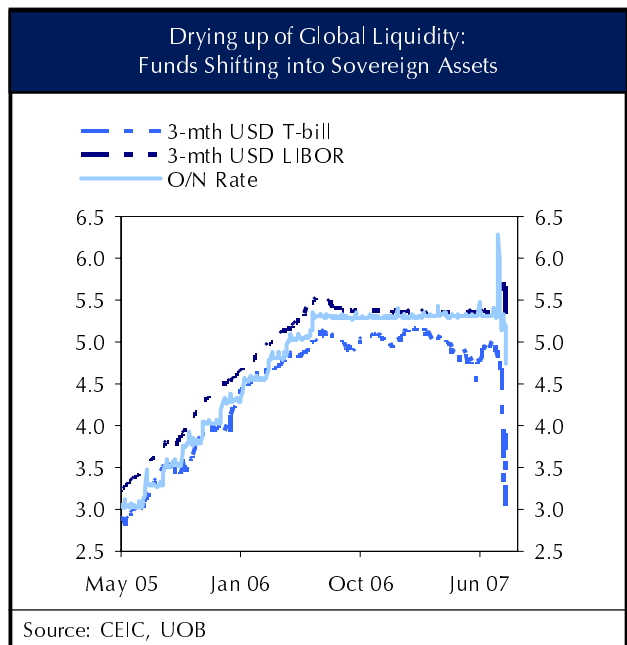
Summary

- As the global credit crunch continues to unfold, there are concerns it could spill into the broader economy.
- Given the strong growth seen in the 2004-2006 period and continuing growth momentum, could the Asian economy possibly have "decoupled" from the US economy?
- The short answer is a qualified "no", given the dominance of the US economy as well as the structure of Asian economy itself.
- However, there are some mitigating factors that would cushion the slowdown, but these are unlikely to be sufficient to counter a severe recession in the US economy.
- Among the key sign posts to watch include the post-FOMC statements, easing/worsening of stresses in the credit markets, and movements of USD/JPY which are key signals of risk aversion/taking.

Credit Markets Under Stress

As a recap of the raging credit crunch episode, our take is that sub-prime mortgage issue is 'genuine', but

'quantifiable'. In addition, the current credit woe is a liquidity issue, but can be resolved thru Fed rate cuts. A flight to safety is evident during the Aug-Sep period, with the LIBOR rates spiking up as funds flow into the relatively safe Treasury instruments.



We believe this is not another "Asian crisis":

- Economies are adjusting much faster, and prices are slowly coming back. Indeed, it appears that prices are more distressed than assets themselves.
- Asian crisis was a 'default' issue, but current credit woe is a 'liquidity' issue - which can be resolved through central bank injection. In 1998, after the dust settled, there were very little funds available. Now, there is still money in the system.
- With current Fed Funds rate at 4.75% (as at 3 Oct), there is still room for rate cuts. If rates were at 1%, then we would be worried.

What could go wrong in the current episode? If anything, it is policy failure, where the Fed (or other central banks) is too slow to cut/react. The alternative scenario is that the credit woes continue to spread into the broader economy, but we are not there yet.

Has the Asian Economy Decoupled?

One question that's often asked is that if the credit crunch does spill over onto the broader economy in the US, would the Asian economy be able to escape from the fallout? The strong growth seen in Asia in the 2004-6 period and continuing strong momentum would lead one to believe that Asian economies may have "decoupled" from the US and could stand on its own.

The answer, however, is a qualified 'no'. This is because the US economy continues to dominate and as the pace of globalization accelerated through the years, the Asian economy has become even more export dependent, and an increased part of Asia's GDP growth has been driven by trade surpluses. A recent simulation done by the Asian Development Bank (ADB) suggests that declines in the US growth rate continue to have a non-trivial impact on Asia's economic growth, just by considering trade linkages and disregarding linkages in financial markets.

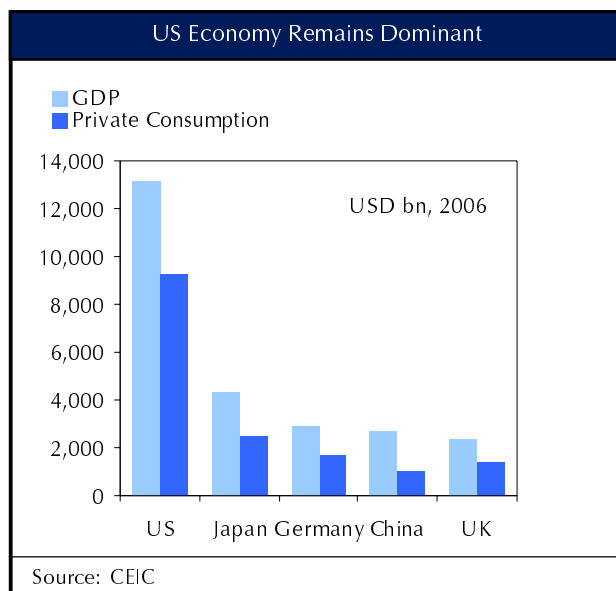
As such, the US economy continues to have a large influence over Asia's economic growth, and it is premature to call for a "decoupling" in our increasingly integrated world economy.

The mitigating factors are that the Asian economy has also become structurally more sound since the 1997/98 financial crisis, and could cushion a "mild" slow-down in the US. In addition, government authorities (including central banks) are more willing (and able) to act, and could offset some of this headwind.

The US Economy Remains Dominant

From the demand side, the US economy is the largest in the world. Its US\$13tn economy accounts for 1/3 of total global economic output and is as large as the

combined output of the next four largest economies. In particular, US private spending is also the biggest in the world, and is close to 1/3 larger than private spending in the EU15. For Asia ex-Japan, the combined output is only 50% of that of the US, while combined private expenditure in Asia ex-Japan is even smaller, at around 20% of that in the US.



Structure of Asian Economy is Still US- and Export-Centric

On the supply side, Asian economies remain export oriented, with China particularly dependent on the American markets. On an average basis, total Asia's exports to the US have declined somewhat to around 16% share in 2006 compared to 23% in 2000.

In the process, Asian countries have become more dependent on China as an export destination, doubling from 8.3% share to 16.8%. At the same time, share of

% of total exports	US		EU		China		Asia ex-China	
	2000	2006	2000	2006	2000	2006	2000	2006
China	22.0	23.0	18.0	22.0	-	-	53.0	47.0
Hong Kong	25.0	16.0	16.0	14.0	35.0	47.0	17.0	17.0
Taiwan	25.0	15.0	16.0	12.0	3.0	23.0	49.0	42.0
Korea	22.0	13.0	14.0	15.0	11.0	21.0	34.7	29.8
Singapore	25.0	15.0	18.0	18.0	4.0	10.0	38.0	34.0
Malaysia	21.0	19.0	14.0	13.0	3.0	7.0	55.9	53.5
Indonesia	17.0	13.0	19.0	15.0	4.0	7.0	44.8	45.1
Thailand	21.0	15.0	16.0	14.0	4.0	9.0	44.3	40.5
Philippines	30.0	18.0	17.0	16.0	2.0	10.0	45.6	47.5
Average	23.1	16.3	16.4	15.4	8.3	16.8	42.5	39.6
Average ex. China	23.3	15.5	16.3	14.6	8.3	16.8	41.2	38.7

Source: CEIC, UOB

ASIA

China's exports to the US has risen slightly to 23% in 2006 from 22% in 2000. Although the change looks minor, the nominal amount has risen significantly, as China's total exports amounted to close to US\$1 trillion in 2006 compared to around US\$250bn in 2000. This fits in the trade pattern that Asia ex-China channels their exports to China, which in turn ships to the US and other parts of the world. This whole cycle then depends on a large extent to US consumption.

For Asia, external trade has also become even more important through the years as globalization increases with outsourcing and offshoring. Total trade (exports plus imports) accounts for close to 100% of Asia's GDP in 2006, almost doubled from 59% in 1990. In particular, total trade used to account for 40% of China's GDP in 2000, and has risen 70% to account for 2/3 of the economy in 2006. For Singapore, this measure is often quoted to be 3 times of GDP, and has increased to close to 4 times of GDP by 2006, suggesting that Asian economies have become even more open, and therefore, vulnerable to a global downturn.

Another indicator of trade dependence is the share of net exports, or merchandise trade balance, in GDP. As can be seen in the table, net exports have become an integral driver of Asia's economic growth, from an average of 0.2% of GDP in 1990, to 4.6% of GDP in 2006. Back in the early 1990s where some countries were running regular trade deficits, and the restructuring since the 1997/98 financial crisis has changed that.

The flipside of Asia's trade-driven economy is that private consumption expenditure has been dwindling, from a 52% share of Asia's GDP 1990 to 47% in 2006. This is an inevitable outcome of tendency in Asia to focus on export-led growth. On an individual basis, most countries have experienced a decline in private expenditure, most notably China, which is increasingly being looked upon as Asia's growth engine given its size. As such, domestic demand within Asia should not be counted on to offset a severe downturn in external demand.

To see the potential impact of a decline in US economic growth, an ADB simulation published in June this year (ADB Working Paper No. 95, "Can East Asia Weather a US Slowdown?") suggests that a 1ppt decline in US economic growth from baseline in two years would translate to around 0.5ppt drop in Asia ex-China growth in each of the two years. The impact on Asia is a non-trivial one and note that the simulation only considered trade linkages and disregarded

Total Trade			
Share of GDP %	1990	2000	2006
China	29.7	39.6	67.0
Hong Kong	217.7	245.7	343.7
Taiwan	74.2	90.9	120.0
Korea	53.4	65.0	71.5
Singapore	300.2	294.0	386.0
Malaysia	139.2	192.1	186.8
Indonesia	43.5	58.0	44.4
Thailand	66.5	107.0	125.7
Philippines	48.2	94.7	85.7
Weighted Average	59.0	73.7	97.7

Source: CEIC, ADB, UOB

Net Exports			
Share of GDP %	1990	2000	2006
China	-0.9	2.9	2.4
Hong Kong	8.6	4.5	11.5
Taiwan	4.9	2.2	5.6
Korea	-0.2	2.9	1.9
Singapore	6.5	13.6	31.7
Malaysia	2.0	19.2	22.3
Indonesia	1.5	9.6	4.1
Thailand	-7.3	9.7	4.4
Philippines	-5.5	-3.9	5.9
Weighted Average	0.2	4.2	4.6

Source: CEIC, ADB, UOB

Private Consumption			
Share of GDP %	1990	2000	2006
China	49.1	46.2	38.3
Hong Kong	56.1	58.9	58.5
Taiwan	54.8	60.7	61.1
Korea	52.3	54.0	53.5
Singapore	46.4	42.2	40.2
Malaysia	51.8	43.8	45.0
Indonesia	58.9	61.7	62.7
Thailand	56.6	56.1	56.1
Philippines	71.2	69.6	70.1
Weighted Average	51.9	51.1	47.0

Source: CEIC, ADB, UOB

financial market linkages. As such, the potential impact could be larger than suggested by this study. However, the positive side is that with Asia's growth projection at around 7.5-8.0% in 2007 and 2008, the 0.5%-1.0ppt decline would still be manageable.

Asia Could Still Weather a Mild US Slowdown

Despite a more integrated global economy, there are reasons that we think Asia could withstand a (mild) slowdown in the US. Structurally, Asian economies

Asia Development Bank's Simulation

Scenario #		Growth Impact (% pt)			
		Asia in Year 1	Asia in Year 2	Asia ex China Year 1	Asia ex China in Year 2
1	1% pt decline US economic growth for 2 straight years (base line 2007 = 2.5%, 2008 = 3.0%)	-0.45	-0.76	-0.42	-0.59
2	Scenario 1 & 10% US\$ decline	-1.85	-1.73	-2.19	-1.11
3	Scenario 1 & 10% decline in China fixed asset investment	-3.42	-0.29	-0.81	-0.93

Source: ADB Working Paper No. 95, June 2007 (http://www.adb.org/economics/erd_working_papers.asp)

have improved significantly especially after the 1997/98 financial crisis. Asian economies have become fundamentally sounder due to the corrective policies that have been undertaken since then.

Overall, most Asian economies continue to build up on savings, while investment expenditure has stayed relatively stable, except for China. Forex reserves have also been built up rapidly since the 1997 financial crisis, allowing the central banks a freer hand in defending their local currencies. Banking sector is now much healthier than before while leverage at both the macro and micro levels has also improved significantly. Corporate leverage, for example, has fallen to an average of 22.5% in 2006 based debt-to-asset ratio from 39.4% in 1998 while operating efficiency (returns on equity) has risen to 14.2% vs. average of -1.5% in 1998.

Against a background of positive macro factors, Asian governments and central banks are able (and more willing) to adopt a more aggressive policy stance to counter any potential external headwinds. The most recent example was, following liquidity injections days earlier by ECB, BoJ, RBA, and others, the mid-August intervention by several Asian central banks to defend

Gross Domestic Savings

Share of GDP %	1990	2000	2006
China	35.2	38.0	47.3
Hong Kong	35.7	32.0	33.2
Taiwan	27.4	24.6	24.7
Korea	37.3	33.9	31.7
Singapore	44.0	46.9	50.5
Malaysia	34.4	46.1	43.0
Indonesia	32.3	31.8	28.7
Thailand	34.3	30.4	29.5
Philippines	18.7	17.3	18.3
Weighted Average	34.6	35.2	39.5

Source: CEIC, ADB, UOB

Gross Capital Formation

Share of GDP %	1990	2000	2006
China	36.1	35.1	44.9
Hong Kong	27.0	27.5	21.6
Taiwan	23.0	23.3	20.3
Korea	37.5	31.0	29.8
Singapore	37.1	33.3	18.8
Malaysia	32.4	26.9	20.7
Indonesia	30.7	22.2	24.6
Thailand	41.4	22.8	31.5
Philippines	24.2	21.2	14.3
Weighted Average	34.4	31.2	35.3

Source: CEIC, ADB, UOB

International Reserves

USD mn	1990	2000	2006
China	34,475.7	171,823.5	1,080,147.7
Hong Kong	24,655.8	107,560.7	133,208.5
Taiwan	77,652.7	111,369.6	270,840.0
Korea	24,448.1	96,253.1	239,134.7
Singapore	27,748.4	80,132.1	136,260.0
Malaysia	10,658.8	28,656.4	82,839.8
Indonesia	8,656.8	29,367.6	42,807.1
Thailand	14,258.4	32,676.7	66,923.1
Philippines	2,036.2	15,108.2	22,818.1
Total	224,591.0	672,947.9	2,074,978.9
Total ex-China	190,115.3	501,124.4	994,831.3

Source: CEIC, ADB, UOB

Debt Service Payment

% of exports	1995	2001	2005
China	9.8	7.9	3.1
Hong Kong	1.8	94.2	...
Taiwan	2.0	0.0	4.9
Korea	7.8	17.2	...
Singapore	0.8	-	-
Malaysia	7.0	6.0	5.6
Indonesia	29.6	23.5	22.0
Thailand	6.8	25.4	14.6
Philippines	15.9	21.2	16.7
Average	9.1	24.4	11.2
Average ex-China	9.0	26.8	12.8

Source: CEIC, ADB, UOB

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Debt to Asset Ratio			
%	1998	2000	2006
Hong Kong	22.5	21.5	17.9
Singapore	53.7	24.0	26.6
Malaysia	27.0	22.8	23.4
Indonesia	50.0	35.8	20.8
Thailand	43.5	44.5	23.6
Average	39.4	29.7	22.5

Source: Bloomberg, UOB

Return on Equity			
%	1998	2000	2006
Hong Kong	11.7	16.9	26.5
Singapore	4.7	13.9	20.1
Malaysia	1.0	4.9	7.1
Indonesia	-24.8	-3.1	13.7
Thailand	0.1	2.9	3.8
Average	-1.5	7.1	14.2

Source: Bloomberg, UOB

their currencies to counter the credit market turmoil.

Little Signs of Decoupling, But...

Overall, the globalized economy and the attendant integrated trading and financial systems mean that "decoupling" is a difficult task to achieve. The Asian economy would still feel the impact of a slowdown in the US economy by virtue of its size and the export-orientation of Asia. As shown in the ADB simulation, the impact from a US slowdown is not small even if only trade linkages are taken account. However, Asia's macro factors have improved significantly since the 1997/98 Asian financial crisis and coupled with expectations of more pro-active central banks, Asia could weather a (mild) slowdown in the US. However, a severe US recession is likely to have more serious repercussions on Asia.

Looking ahead, some of the sign posts to watch include the upcoming US Fed's FOMC meetings (the

Banking Sector NPL			
% of total loans	1999	2001	2006
China	-	29.8	7.5
Hong Kong	7.2	5.7	1.2
Korea	8.3	2.9	0.9
Singapore	5.3	3.6	2.4
Malaysia	16.6	17.8	8.7
Indonesia	32.9	11.0	16.0
Thailand	38.6	10.5	8.9
Philippines	14.6	19.0	18.6
Average	17.6	12.5	8.0
Average ex-China	17.6	10.1	8.1

Source: CEIC, ADB, UOB

next meeting is on 30-31 Oct) and the post meeting statements, which would provide a clue of the assessment of the current credit crunch. On the fx market, the movements of USD/JPY, is another main signal of market assessment of risk aversion.

Asia's GDP Growth							
Asia's GDP growth %	1995	1998	2001	2005	2006	2007F	2008F
China	10.5	7.8	8.3	10.4	10.7	11.5	10.5
Hong Kong	3.9	-5.1	0.6	7.5	6.8	6.0	5.2
Taiwan	6.4	4.6	-2.2	4.0	4.6	4.5	4.2
Korea	8.9	-6.7	3.8	4.2	5.0	4.6	5.0
Singapore	8.0	0.4	-2.4	6.6	7.9	7.5	7.0
Malaysia	9.8	-7.5	0.5	5.0	5.9	5.7	6.0
Indonesia	8.2	-13.2	3.8	5.7	5.5	6.1	6.2
Thailand	6.4	-10.2	2.2	4.5	5.0	4.5	6.5
Philippines	4.7	-0.6	1.8	4.9	5.4	6.6	5.6
Weighted Average	9.1	1.5	5.1	7.7	8.1	8.5	8.0

Source: CEIC, ADB, UOB forecasts