Flight to Safety or Virtue? US, EU, China and Global Economic Growth in 2012

*The first session of the ISIS Praxis Seminar 2012 discussed global economic prospects in 2012. The panelists were **Mr Manu Bhaskaran** of Centennial Group Inc. and **Mr Suresh Kumar** of CIMB Group. **Dato' Dr Mahani Zainal Abidin** (ISIS) Malaysia moderated the session. ISIS Researcher, **Nor Izzatina Abdul Aziz** reports.*

Mr Manu Bhaskaran's presentation covered the global economic outlook for 2012 and its implications for Asia while Mr Suresh Kumar spoke on the currency market's reactions given the 2012 outlook of shorter business cycles and amplified risk aversion.

The trifecta of global economic growth – the United States, European Union and China -- all have internal imbalances that will have negative repercussions on world economic growth in the near future. The current global economic outlook therefore does not look bright.

Doubts about the possibility of the world economy growing in 2012 are increasing due to recent events like the European Debt Crisis, the downgrading of US debt ratings and the deadlock amongst US policymakers over US debt ceilings. While China currently looks like an oasis, its internal imbalances are yet to rise to shake the international community.

Due to these events Bhaskaran said that substantial downside risks exist for near term economic growth. He pointed out that the global impacts of these events are worse than was expected and they can hurt Asian economies. It is because of the economic weight carried by the US, Eurozone and China in the world economy that the effects of their internal imbalances will spread to other countries (Table 1).

(From left) Suresh Kumar, Mahani Zainal Abidin and Manu Bhaskaran

Table 1

Country	% World GDP	Outlook
United States	23.1	Unclear sustainability
Eurozone	19.3	Recession and debt crisis spreading to core countries like Italy
China	9.3	Informal financing unraveled due to 2011 credit tightening. Lower 2012 inflation
Japan	8.7	Rebound less than hoped
Other emerging countries	8.3	Clear signs of slowdown

Apart from country-related problems that dampen the future economic outlook, there are several other cross-cutting factors that continue to hamper future growth, such as tight global credit mechanisms, volatile capital flows and oil prices, slower industrial commodities growth, higher food prices and weakening tech spending. These factors alongside imbalances in the world's three biggest economic regions, will affect Asia's growth potential in the coming years.

It is natural for oil prices to be low during an economic slowdown. However with the current geo-political situation in the Middle East, world oil price is highly dictated by the risk premium attached to it. Political risk in oil-producing Middle East countries like Libya will not stabilize quickly given the lack of strong institutions and leadership.

Recent economic improvements experienced by the United States will not last as these were achieved by borrowing growth momentum from 2012. The US savings rate, for example has fallen from eight per cent in January 2010 to 3.6 per cent in late 2011. Sources of growth such as private investments are also expected to be low in the future given the expiry of incentives on capital expenditure investment in December 2011. There is also a high possibility that losses from European branches of US financial firms' will be transferred to the US, affecting domestic credit market confidence.

At the same time, the US government's fiscal situation has not been fully resolved and the outcome will be highly dependent on the willingness of political parties to consolidate differences on stimulus and government spending so as to ignite US growth potential. The impasse has resulted in the downgrading of the US sovereign bond rating. Markets have been reacting erratically to the impasse while policymakers in the US decided to calm the market with the implementation of Operation Twist.

The aim of that Operation was to flatten the yield curve of the US and among its repercussions has been an increase in the dollar value internationally, leading to an increase in trade's financing cost in the Asian asset market. Given the lack of success of QE1 and QE2, the efficacy of Operation Twist is questionable and it has been unable to inspire confidence.

The sovereign debt crisis experienced by smaller EU economies like Greece is now likely to spread to other bigger economies like Italy and Spain. With dim growth prospects, and the implementation of austerity packages to improve credit-worthiness, the downward spiral trend of these economies is expected to continue. Increasing political backlash in the region has also restricted government policy space. As a result, troubled EU economies found it harder to establish credit lines from private lenders and now have to turn to the European Union and its Central Bank to pull them out from the spiral.

The EU's inability to address its current crisis stems from its unification design flaws. Any solution proposed could create a new problem because it can weaken the EU mandate. Because of the EU's centralized monetary policies but decentralized fiscal policies, member countries cannot make necessary adjustments if the other members' policy actions are ineffective. Bhaskaran explained that while the EU has a safeguard mechanism, the European Financial Stability Facility, its ability to bail out members is limited.

Bhaskaran said that the EU is likely to evolve into a 2-tier Eurozone — North and South — the northern states like France and Germany will follow the ideals of the Maastricht Treaty while the rest will be left to deal with their own financial losses and political problems.

Kumar said that while the temporary separation from the EU will give monetary policy autonomy to troubled economies, it will also create currency risks in the international financial market. To substantiate his point, he pointed out that the European Investment Bank's issue of long-term financial instruments has started to factor in currency risk premium in Euro-denominated commercial papers, expecting the temporary break of these economies from the EU.

In the case of China, Bhaskaran believes it is reaching the turning point in its internal imbalances and that will determine whether the nation will undergo a soft or hard landing in 2012. The expected downturn in China will originate in imbalances in its input, and external and capital markets. Its input market is facing power shortage and the rising cost of wages while its ability to grow through external factors looks doubtful due to weaker demand from importing countries like the US and Eurozone. The expected huge impacts of the corrective monetary policy actions of 2011 to counter inflation, bubbles and excess capacities will only be felt in 2012.

Manu Bhaskaran

Kumar agreed with Bhaskaran's view that China's economy will undergo either a soft or hard landing in 2012. He added the exchange rate dimension to China's economic assessment by pointing out the yuan's unique situation. The main reason for this is the difference in Yuan values between Mainland China and its offshore market, Hong Kong. The Yuan value in Mainland China has been very stable but its value in Hong Kong factored in activities like forwarding and call options by corporations.

The conditions affecting the EU, US and China will have negative impacts on Asian economies given the latter's interdependency and connectivity. Key differences from the 2008 Crisis include:

- Strong credit mechanism (especially for trade financing). However, as exhibited in 2008, this situation can flip quickly;
- Limited policy responses from the US, EU, and China. It is not feasible for them to undergo another round of massive stimulus packages given worsening government finance and hostile political moods and social unrest.

The expected recession in advanced countries, and the growth slowdown in China and the rest of Asia point to a new trend of shorter business cycles that run between six and nine months and greater uncertainty. Economic agents will somehow need to adapt their strategies to this new reality Kumar said.

Suresh Kumar

While the risk of a downturn exists, the majority of Asian countries observed by Bhaskaran have shown improved resilience in their preparedness to face a global slowdown compared to their responses during the 1997 and 2008 crises. While the resilience index measuring these countries on average is high, the resilience indices of several countries like China, Hong Kong, Malaysia, Philippines and Vietnam have fallen slightly since the 2008 crisis.

Reasons for the decline can be found in the rise of private and public sector debt. Within Asean, the situation in Vietnam looks the worst as resilience tests have shown the nation is at critical levels in its preparations for an inflation surge, currency stress or financial shock.

Asian economies have not fully decoupled from the important trifecta of economic growth — the US, EU and China. They have a relatively high exposure to the Eurozone crisis via trade and financial channels. 21.2% of China's trade flows for example went to Europe while countries like Singapore and South Korea have greater exposure due to the high proportion of loans originating from the EU.

Political situations will also influence financial markets, as several important elections such as those in the United States, Russia and France will be held in 2012. In Asia, political changes are expected in China, Taiwan and Korea either due to natural transition as in China or elections.

A downside is expected in the Asian currency market given the expected rise of the US dollar said Kumar. A shortage of dollars is expected in Malaysia, India and Korea due mostly due to central banks' strategy of maintaining a mixed basket of currencies by lowering the US dollar holding. The situation in the EU has also reduced the Euro's value. As the value of the dollar increases, the risk in Asia's credit market is expected to increase as well due to debt denomination and increasing interest rates spread.

The session ended with the general conclusion that due to troubles in the EU, US and China, Asia will not be fully shielded from the downturn that is expected in 2012. On a positive note, Asian economies are now better prepared than they were during the crises of 2008 and 1997.