Euler Hermes Economic Research

Economic Insight

Three Asian Tigers caught in a (Chinese) Typhoon

August 3, 2016

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Executive summary

- Hong Kong, Taiwan and Singapore are caught in an economic typhoon. Activity growth will be hindered by depressed external demand, especially from China (lower demand, economy's upgrading) and tighter financial conditions, including contagion risks. All three economies will grow below +2% in 2016-17, far below their long-term average.
- In the short run, resilient domestic demand will come from reactive policy-making and stimuli in the pipeline are promising to safeguard growth. In the long run, each hub will have to diversify and reinvent its business model. Hong Kong appears to be the least agile and the most affected by Chinese woes. Taiwan has a strong innovation edge but China becomes a stronger contender. Last, Singapore will benefit from past diversification and branding efforts especially of its business environment and logistics.
- In 2016, insolvencies will increase by +15% in both Singapore and Hong Kong, and by +17% in Taiwan. Vulnerable sectors include basic materials (too low prices), retail and electronics (Chinese collateral damage), and housing and real estate (leverage).

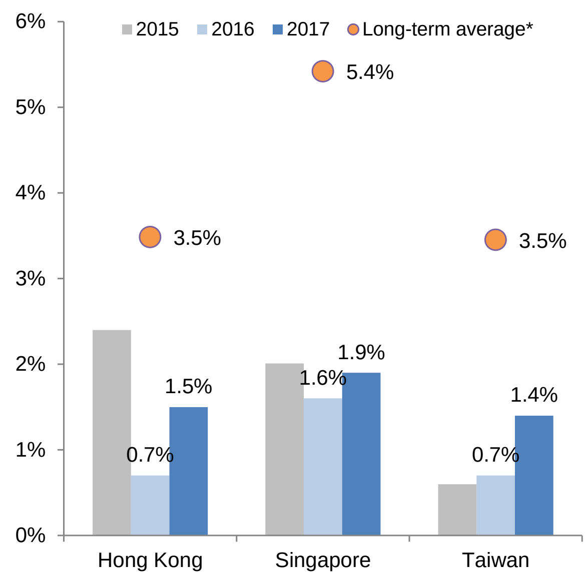
Caught in a typhoon?

The first half of the year has been rough for the three Asian Tigers: Singapore, Hong Kong, and Taiwan. Taiwan is struggling to recover from a recession, Hong Kong has to deal with a potential hard landing and Singapore alternates short periods of expansion and contraction.

Going forward, the three export-oriented economies will post below +2% growth in both 2016 and 2017, far from their respective long-term average (see figure 1). Growth will be hindered by depressed external demand especially from China and tough financial conditions. Policy-making will be key but negative spillovers include higher corporate risks.

The second half of 2016 could then be a turning point for Hong-Kong as the risk of technical recession increases on the back of prolonged weak demand from China and tighter monetary conditions. In Taiwan, lower demand from China (exacerbated by political tensions) and strong price competition from neighboring countries (including South Korea and China) are the two top risks to watch. As for Singapore, the broad easing approach, a slightly more diversified export structure (products and destinations), and more competitive prices should help.

Figure 1: Real GDP growth



** Long-term average refers to the average GDP growth per year over the 2004-2014 period.*
Sources: IHS, Euler Hermes

Chinese headwinds

Lower external demand will be the main drag for all three economies: they are small and highly open, making them very sensitive to the global trade momentum. We estimate that a 1 point decrease in global trade can shave up to -0.7pp off Singapore GDP, and -0.5pp off Taiwan and Hong Kong GDP (see figure 2). For Hong Kong (-0.3pp) and Taiwan (-0.2pp), China would matter the most whereas for Singapore, the ASEAN block matters more (-0.2pp).

Along with sluggish trade growth this year (+2.2%), China's demand will disappoint (+6.5% from +6.9% in 2015), especially since it includes slower private investment growth and weaker trade. In addition, the upgrading of the economy will continue (see figure 3), and local suppliers will replace foreign ones, especially those located in the trade hubs. When these two phenomena are combined with the lower purchasing power caused by a weaker RMB, Hong-Kong, Taiwan and Singapore, in that order, will experience lower export of goods and services (tourism and financial ones), and reduced retail sales. Hong-Kong is in the eye of the storm: Goods exports represent 88% of GDP and the HKD is (too) to be competitive. For Taiwan, China represents c.15% of GDP but frontal competition (electronics) and tense political relations are important to note.

Hot and humid markets

In all three markets, financial vulnerability is also high (see figure 4): foreign capital flows and stock markets matter more than in other Asian economies. Subdued economic prospects and tighter global financing conditions with upcoming Fed hikes could be a deterrent to capital inflows. In addition, a rise in global risk aversion may affect domestic stock markets through contagion and lower capital inflows. Prolonged uncertainty around the Brexit outcome (*Soft leave or Hard leave from the E.U*.), to which financial ties are obvious (yet limited), and negative economic news from China (corporate debt at 169% of GDP; misperceived policy orientations) could trigger regional anxiety.

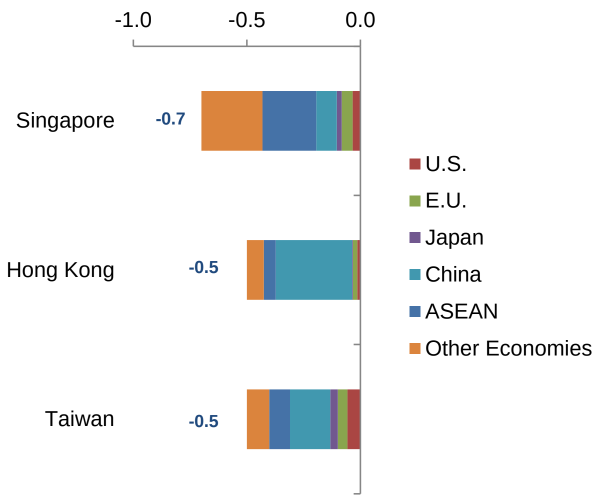
Storm safety tips: Reactive policies and Perspective

Policy activism will make a difference

Policy support will probably be the main driver in the short run. Authorities have strong buffers including strong public finances, and current account balances (see figure 5) which give them leeway to stimulate economic growth.

On the fiscal front, governments in Hong Kong and Singapore have already unveiled pro-growth budgets, with measures to support SMEs, households, fragile sectors and economic agents (for example, low-income elders). The total package is set to provide a boost of +1.1pps of GDP for both. The impact should materialize from Q2 onwards as the budgets were agreed in Q1. Taiwan has been more cautious, constrained by a tough legal framework that limits central government debt at 40.6% of GDP (currently 35.6%) and an unfavorable political context (elections). As a matter of fact, the current 2016 budget is less expansionary and more selective

Figure 2: Direct impact of a -1pp decrease of partner's import demand on Asian Trade hubs (in pp)



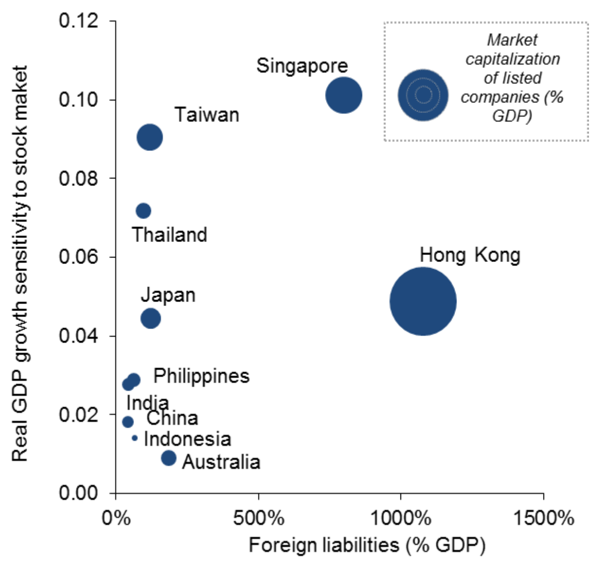
Source: Euler Hermes

Figure 3: China's upgrade in 7 indicators

	2010	2014
Medium - High Tech goods exports (% total goods exports)	56	57
Exports to Imports ratio for Medium - High Tech goods (in %)	150	172
Gross domestic spending on R&D (% GDP)	1.7	2.0
Researchers (per 1000 employed)	1.6	2.0
Resident patent applications (per 1000 people)	0.2	0.6
Profit in High Tech industry (RMB bn)	488	810
of which Electronic and Communication Equipment	223	374

Sources: World Bank, OECD, Chelem, National Statistical Office, Euler Hermes

Figure 4: Financial vulnerabilities indicators



trying to address both cyclical hurdles (through high social welfare spending) and long-term issues (through technology outlays). We expect a modest fiscal boost of +0.5pps of GDP this year.

On the monetary front, Taiwan is much more proactive. The Central Bank embarked on an easing monetary cycle since last year to boost private demand. Further easing is likely by the end of the year (-25bp) considering that GDP growth is still weak, inflation low (+0.9% y/y in June) and credit growth continues to slow (see figure 6). In Singapore, last April, the Monetary Authority shifted to a zero appreciation of the SGD nominal effective exchange policy band (previously a modest and gradual appreciation) in the wake of lower inflation and tepid global demand. Such a move will help alleviate deflationary pressures and make exports more competitive. Hong Kong will be the most disadvantaged. The Hong Kong Monetary Authority adopted a hawkish stance in accordance with its exchange rate policy. Key interest rates moved up in tandem with the first U.S. Fed hike. Assuming that the Fed will maintain its hawkish stance, domestic borrowing costs will remain elevated, acting as drag on growth.

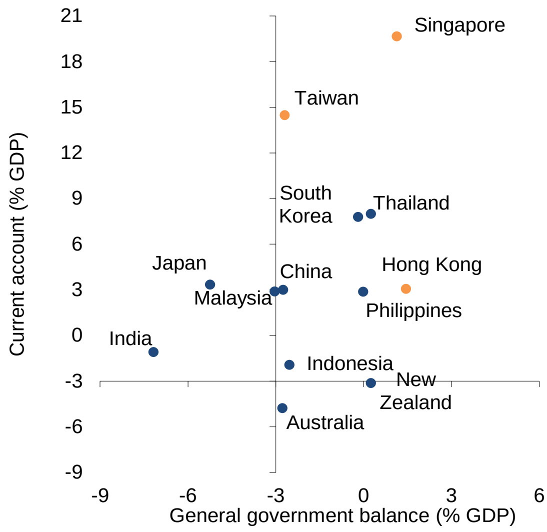
(Long-term) differentiation strategies will be pivotal

In the longer term, sustainable growth will be conditioned by an increase in investment. While demand plays a significant role in investor confidence, efficient specialization will matter.

In that regard, Hong Kong again is the laggard. Over the past years, the economy did not take up the opportunity to diversify and to move up the value chain. On the contrary, the competitive edge of the electronics industry (see figure 7) has been lost and the country has focused on complementarities to the Mainland (high-end retail trade, financial industry and logistics activities). These sectors have benefitted from the rising middle class and industrial awakening without a full-fledged financial marketplace. The tide is turning on all fronts as China catches up (in a bumpy way when it comes to income growth). A sound business environment, high financial openness and strong expertise will help maintain Hong Kong as a strategic financial hub for business related to the Mainland. However, hyper-concentration (finance and China) comes with hyper vulnerabilities.

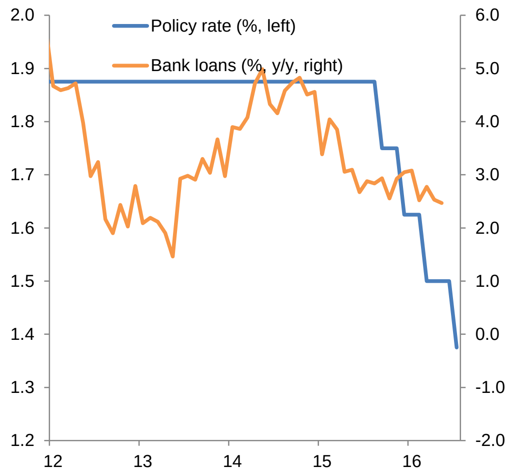
Taiwan is at a crossroads. Considerable efforts to invest in Research and Development (see figure 8) have strengthened its position in the global value chain. However, the strong reliance on electronic components, the dependence on Chinese outlets and the increased regional competition are serious threats. Maintaining its innovation edge will be key and should come with further value chain integration, including development of downstream industries and further diversification (partners and products). Authorities have committed to developing trade with other partners and invest in five innovative industries including the tech and biotech industry (Asia's Silicon Valley), smart machinery, green energy, the Internet of Things (IoT) and the defense industry. The road will be long.

Figure 5: Fiscal and current account balances (% GDP)



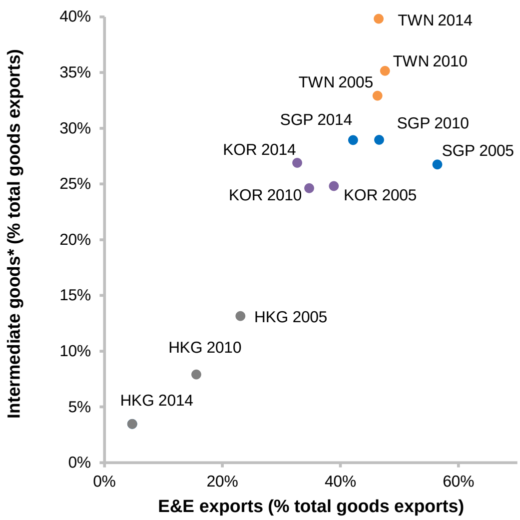
Sources: IHS, Euler Hermes

Figure 6: Monetary policy (Taiwan)



Sources: IHS, Euler Hermes

Figure 7: Intermediate and Electrical and Electronic (E&E) goods exports (excluding re-exports)



N.B: SGP= Singapore; HKG= Hong Kong; KOR= South Korea; TWN= Taiwan
Sources: Chelem, Euler Hermes

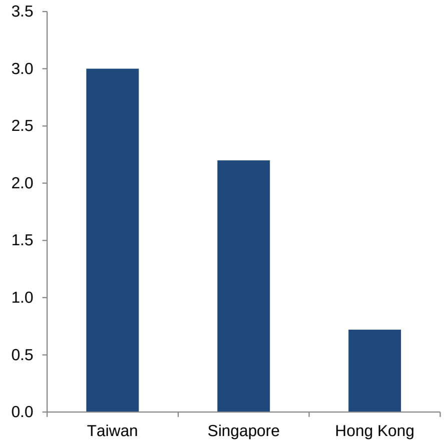
Singapore is the best positioned so far. The economy has diversified economic ties (the U.S., Japan, China, ASEAN and the E.U.), a solid innovation ecosystem (including Academia), and a strong business environment including a top-notch logistics infrastructure (see figure 9). Singapore is home to leading actors in the biotech and Pharmaceutical sector, on top of electronics. Moreover, the authorities continue to invest in logistics and soft infrastructure, in economic partnerships (with Africa e.g.) and in stability for its branding: a way to secure its position as a strategic hub.

Unwanted casualties: Bankruptcies expected in selected sectors

Companies will be the main victims of the bad weather conditions while the Asian Tigers seek their next business model. Insolvencies are expected to increase by +15% in both Singapore and Hong Kong, and by +17% in Taiwan. Companies' turnovers are still on a downward trend, in line with weak industrial production, retail sales, and prevailing deflationary pressures. There is no reason to expect a regime switch anytime soon.

Sectors at risk include: (i) basic materials (oil and gas, mining), especially in Singapore as negative price shocks hinder profitability; (ii) retail, especially in Hong Kong hampered by lower tourist arrivals from the Mainland and erosion of price competitiveness; and (iii) electronics for Taiwan where China decided to make a move with the development of new industry, more competitive and higher up un the value chain; and (iv) property market and the construction sector because of the important financial debt component. In Taiwan and Singapore, these sectors have started to adjust with pro-active cooling measures such as unfavorable tax regimes and a more conservative monetary stance. In Hong Kong, the Government also implemented measures (Special Stamp duty in 2012) to curb the overheating markets but a low -interest rate environment at that time has slowed the process. With the tightening of financing conditions at end-2015, the market has started to adjust as exemplified in household debt proxies (see figure 10).

Figure 8: Research and Development (% GDP)



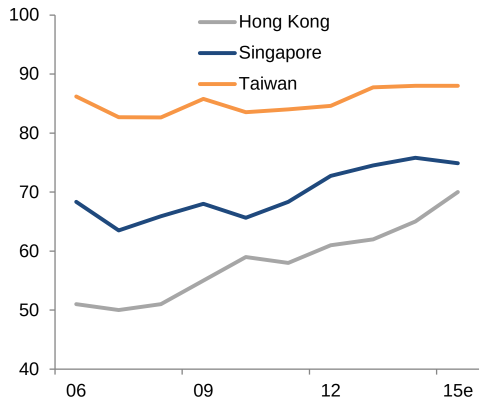
Sources: OECD,IMF, Euler Hermes

Figure 9: Key surveys ranking (1 = best)

	Logistics Performance Index	Doing Business
Singapore	5	1
Hong Kong	9	5
Japan	12	34
Taiwan	25	11
China	27	84

Sources:World Bank, Euler Hermes

Figure 10: Household debt (% GDP)



N.B. : For Taiwan and Singapore,it refers to households liabilities.
Sources: National Sources, Euler Hermes