

EM Asia: The Trade Engine Has Broken

FEBRUARY 11, 2016



- Asian economic growth has slowed markedly in recent years, but even more worrisome is the collapse in Asian trade (Charts 1&2). Our analysis suggests that the changes depressing Asian trade have been mostly structural in nature.
- We expect Asian economic growth to remain disappointing in 2016, and we see little chance of a significant rebound in trade despite weaker currencies. Asia will have to find new engines of growth. Past elasticities between growth and Asian trade will not be a good guide for forecasting trade growth.
- In recent years, Asian trade has become increasingly China-centric. This vertical integration has reinforced business cycle synchronization. The Chinese engine for Asian trade is unlikely to be reignited soon. Chinese growth is becoming less import intensive as supply chains are becoming more integrated onshore and the weight of services is increasing. Moreover, the U.S. is not playing the role it used to play. The U.S. expansion has failed to trigger a rebound in global trade, as it is increasingly focused on the service sector (see [The Rise of Services—What It Means for the Global Economy, December 2015](#)).
- The only scenario under which China could become an engine of global trade again is a massive new fiscal stimulus. We should, however, be careful what we wish for as this scenario would not drive the economic transformation China needs and could end up in a fiscal crisis in China.
- For Asian exports to enjoy a sustained rebound, a deepening of intraregional horizontal trade ex-China would be necessary. Improvements have been slow in that regard given the relatively high level of product similarity and that vertical integration around China has diluted attempts to develop more horizontal integration across Asian countries.

JC Sambor
DIRECTOR, ASIA/PACIFIC
+65 6592 5088
jcsambor@iif.com

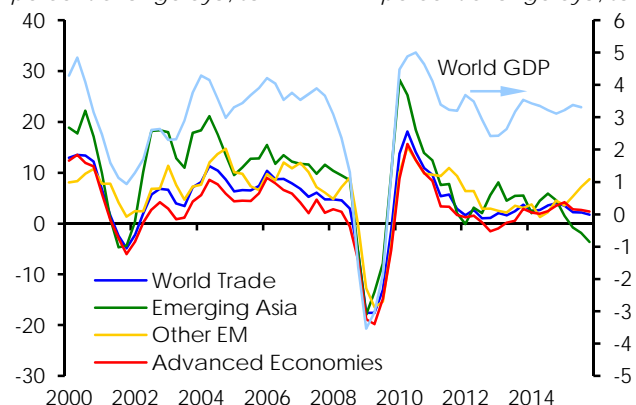
Kevin Sanker
ASSOCIATE ECONOMIST
+65 6592 5086
ksanker@iif.com

Chart 1

Merchandise Trade Volumes and World GDP

percent change oya, sa

percent change oya, sa

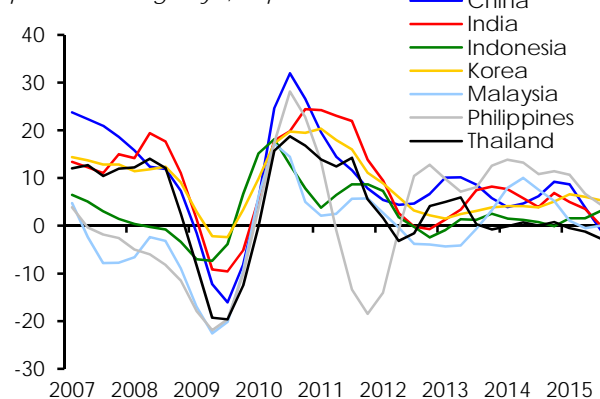


Source: CPB, Haver, IIF. Q4 2015 = Oct-Nov.

Chart 2

Merchandise Export Volumes

percent change oya, 3-quarter ma



Source: UNCTAD, IIF.

DISAPPOINTING ASIA GROWTH, COLLAPSING ASIA TRADE

Global economic growth has slowed, but trade has collapsed. As global GDP growth has stagnated following the short-term rebound post-financial crisis, trade volumes have struggled even more. The drop in EM Asia volumes has been more dramatic and notably worse than other emerging markets. Within Asia, China has been particularly weak, but most other countries' exports have also faltered. Only a few countries such as the Philippines, which seems to be gaining market share in specific electronics sectors, and Korea, where the IT front has been relatively resilient, have managed to keep positive export volume growth. In Asian frontier markets, Vietnam has continued to benefit from the relocation of lower added value manufacturers away from Chinese coastal provinces.

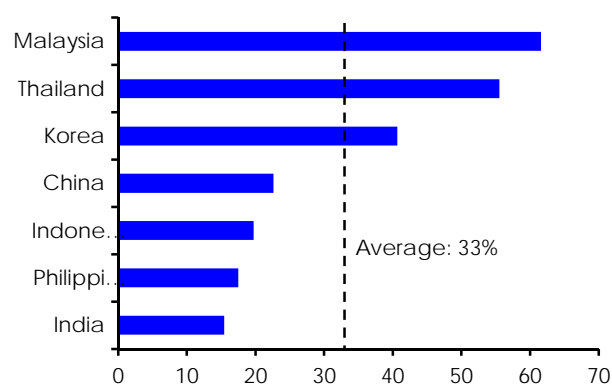
As EM Asia countries have relied heavily on exports as a significant growth driver (exports account on average for 33% of GDP with significant disparities) (Chart 3), the sluggish global trade environment has undoubtedly contributed to weaker regional performance.

Asian export weakness has been even more pronounced in value terms (Chart 4). In addition to weaker external demand, the fall in global commodity prices has also played a role. India, Indonesia, and Malaysia stand out in this regard as their dependence on commodity exports has contributed to a larger drop in exports receipts (Charts 5&6). Manufactured goods exporters such as Philippines or Thailand have only done marginally better, however, as global manufacturing prices have also declined.

BE CAREFUL WHAT YOU WISH FOR

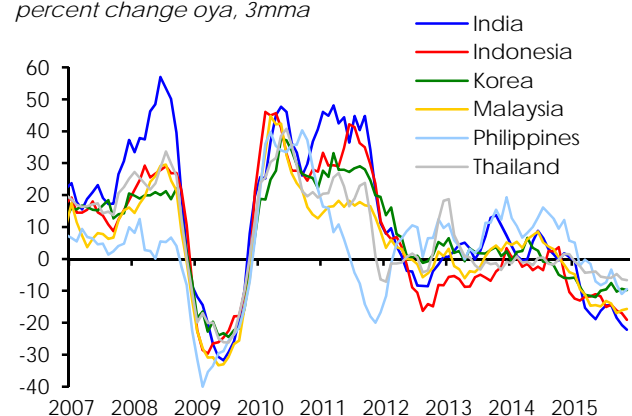
The recent setback to Asia trade needs to be seen in the context of the dramatic trade globalization over the past twenty years, which was particularly prominent in

Chart 3
Merchandise Exports
percent of GDP



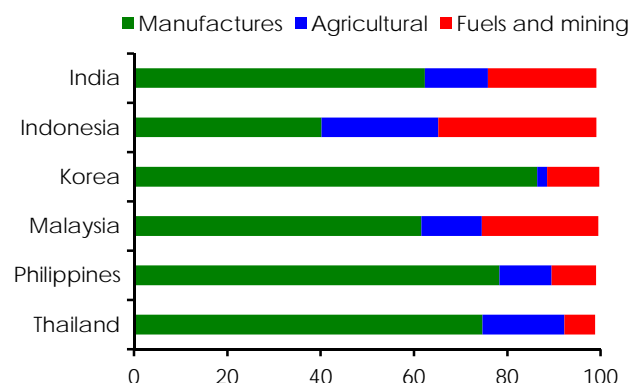
Source: National Sources, IIF.

Chart 4
Merchandise Exports
percent change oya, 3mma



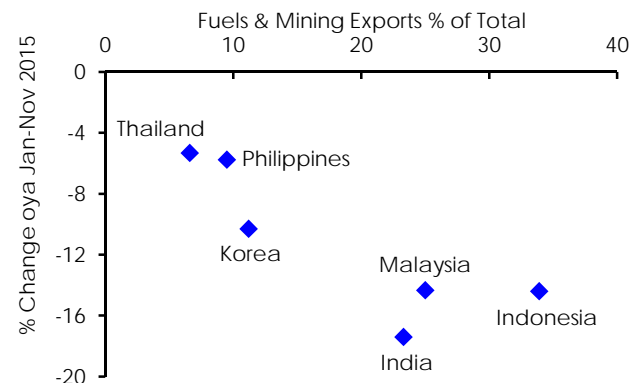
Source: National Sources, IIF.

Chart 5
Merchandise Exports by Type
percent of total



Source: WTO.

Chart 6
Total Merchandise Export Growth vs. Fuels and Mining Share
% change oya Jan-Nov 2015; fuels & mining exports % of total

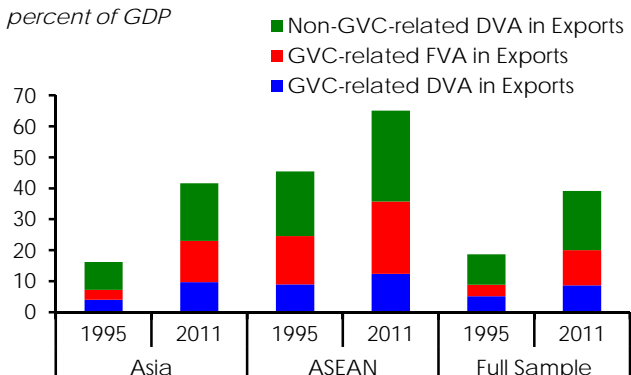


Source: National Sources, WTO, IIF.

Asia. This process was driven by vertical trade integration (Chart 7). Asian exports have been increasingly integrated in the overall supply chain. At the country level, the share of foreign value added embedded in exports significantly increased in China while the increase has been more gradual in India, reflecting the lower integration of India in the Asian supply chain (Chart 8). Overall, Asian vertical integration has been more rapid than in other parts of the world.

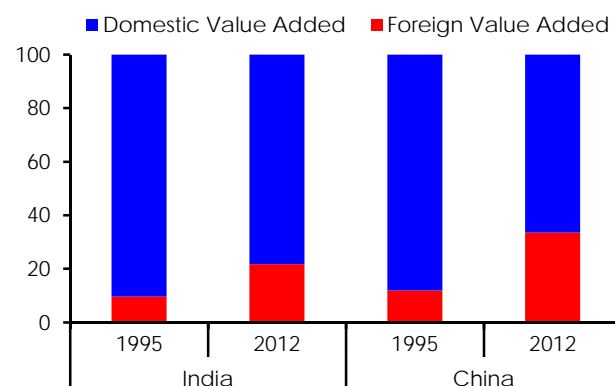
At the same time, Asia has become increasingly dependent on emerging market demand. The share of EM Asia ex-China exports to emerging markets has risen to 53% from 28% in 2000, nearly half of which are outside Asia. The share of advanced markets has steadily declined (Charts 9&10). The recent resilience of the Philippines might be partially explained by a still high share of exports to advanced economies, primarily the U.S. Given the export dependence on emerging markets in many EM Asia ex-China countries, the recent slowdown in emerging market economic growth and import demand have contributed to the pronounced weakness in regional exports.

Chart 7
Decomposition of Gross Exports
percent of GDP



Source: IMF. DVA = domestic value added; FVA = foreign value added; GVC = global value chain. Full sample spans 88 advanced and emerging market and developing economies.

Chart 8
Domestic and Foreign Value Added Embedded in Exports
percent of total gross exports

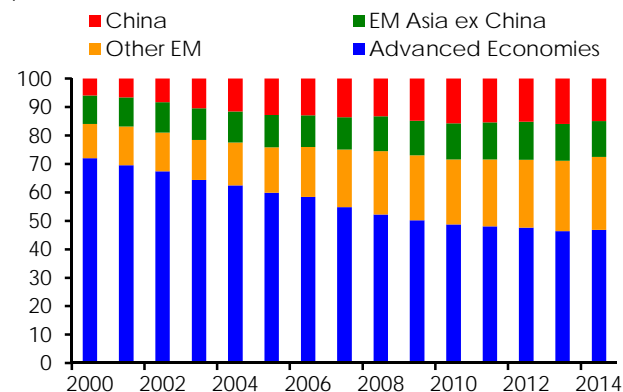


Source: IMF. Values for 2012 are estimates.

Chart 9

EM Asia ex China: Merchandise Exports

percent of total

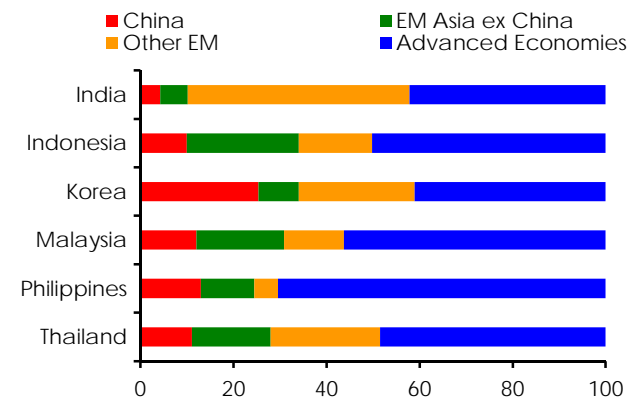


Source: Haver, IIF.

Chart 10

EM Asia ex China: Merchandise Exports

percent of total



Source: Haver, IIF.

Although EM Asia exports to China fell by 4% y/y last year through August, the drop in exports to advanced economies and other emerging markets was even more pronounced (Chart 11). The recent slight rebound of exports to China seems to be explained by one-off commodities exports from Indonesia and Malaysia (see individual countries charts in appendix). Overall, stronger U.S. demand has not been sufficient to provide meaningful support to Asian exports this time around. A modest U.S. expansion cannot be the engine of global trade anymore.

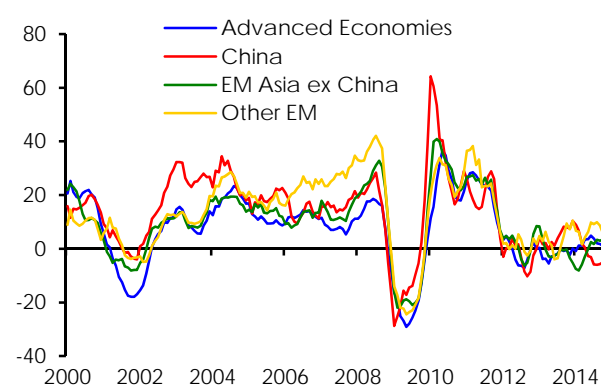
LEARNING TO LIVE WITH CHINA'S NEW NORMAL

Global trade with China has surged since its WTO entry in 2001 to account for 23% of world trade. The rapid pace of China's export market share gains has been reflected in the large differential between China and world export growth (Chart 12).

Chart 11

EM Asia ex China: Merchandise Exports

percent change oya, 3mma

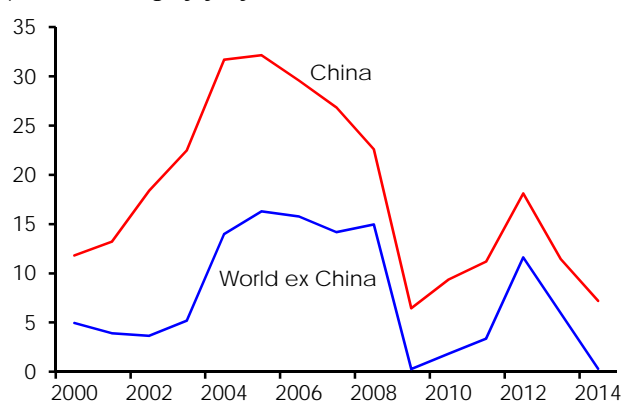


Source: Haver, IIF.

Chart 12

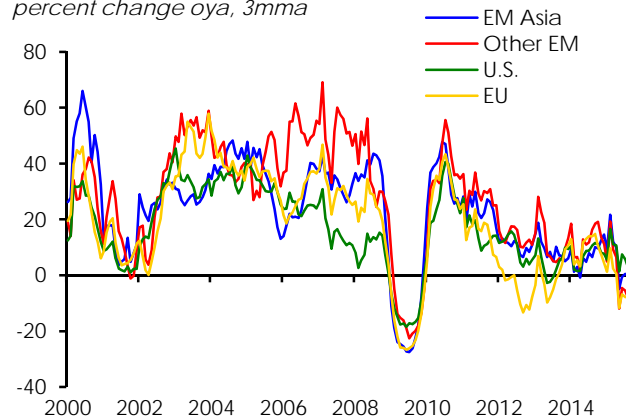
China: Merchandise Exports

percent change y/y, 3yma



Source: Haver, IIF.

Chart 13

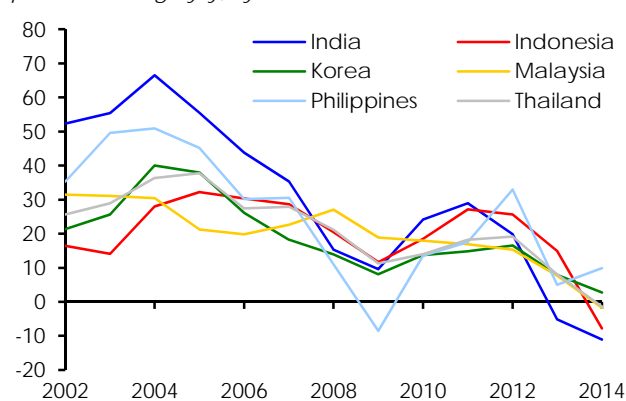
China: Merchandise Exports*percent change oya, 3mma*

Source: Haver, IIF.

More recently, however, China has not been immune to the slowdown in global trade (Chart 13). Despite some recovery in exports to the U.S., overall Chinese exports have remained extremely weak and have shown few signs of recovery.

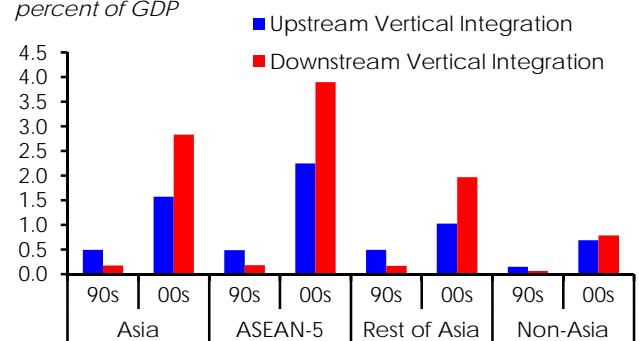
As Asia trade has become increasingly China-centric and vertically integrated, what was once a blessing is now turning into a curse. China's marked trade slowdown has had negative spillovers across Asia. Asia's vertical trade integration with China has increased significantly both on the downstream and upstream sides (Chart 14). EM Asia exports to China have risen from 8% of total exports in 2002 to 15% in 2014, after reaching a high of 15.8% in 2013. However, the pace of growth has declined steadily from the fast rates of the early 2000s (Chart 15). This trend continued through 2015, with all countries in EM Asia experiencing declines in export growth to China last year through the third quarter. This slowdown has had a particular impact on domestic growth in countries such as the Philippines and Korea, which have a particularly high share of domestic value added in exports to China (Chart 16).

Chart 15

Merchandise Exports to China*percent change y/y, 3yma*

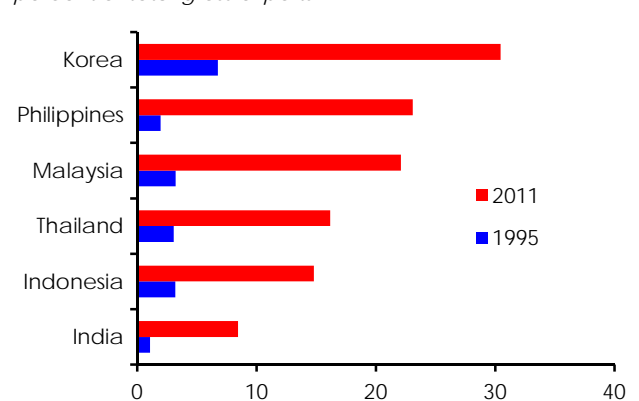
Source: Haver, IIF.

Chart 14

Median Vertical Trade with China*percent of GDP*

Source: IMF. Upstream vertical integration of China with country j is defined as value added from China embedded in country j's exports; and downstream vertical integration of China with country j is defined as value added from country j embedded in China's exports.

Chart 16

Domestic Value Added in Exports to China*percent of total gross exports*

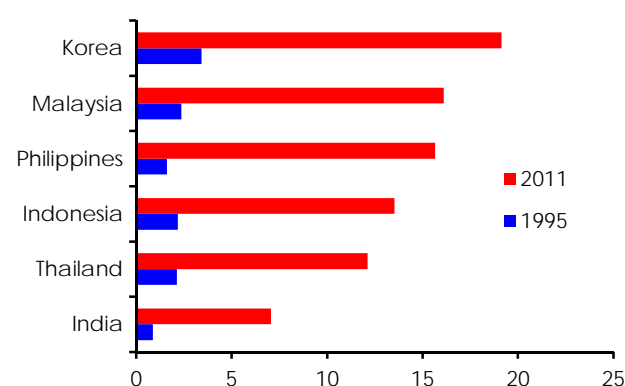
Source: OECD.

Chart 17
China Processing Imports and EM Asia Exports to China
percent *percent change oya, 3yama*



Source: CEIC, IIF.

Chart 18
Domestic Value Added in Final Demand from China
percent of total foreign final demand



Source: OECD.

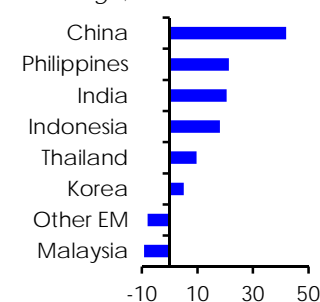
The recent weakness of Asian trade with China reflects a triple whammy.

- Chinese demand for imported intermediate goods is contracting as China has incorporated more domestically-produced content into its exports. China's processing imports' share of exports was fairly steady in the early 2000s, but has fallen since 2005, which closely coincides with the beginning of the slowdown in growth of EM Asia exports to China (Chart 17).
- Chinese final demand is slowing down, particularly for goods. This shift will impact countries with exports with high domestic value added related to final demand in China, with Korea likely being the most affected, though other countries such as Malaysia and Philippines could suffer also (Chart 18). India should be the most resilient country given its lesser exposure to Chinese final demand and lower domestic value added in exports to China.
- Finally, the Chinese economic structure is gradually rebalancing towards the service sector. As a result, China is less import intensive than a few years ago (see [China Spotlight: Can Services Drive the "New China"? , January 2016](#)). While we do expect Chinese growth to rotate away from services temporarily (as the contribution of financial services should come down) and infrastructure investment might pick up again in the near term, we think this acceleration in goods demand should prove temporary and is unlikely to trigger a broad-based and sustainable recovery of Asian exports.

NO BROAD-BASED REBOUND IN ASIAN EXPORTS IN SIGHT DESPITE WEAKER CURRENCIES

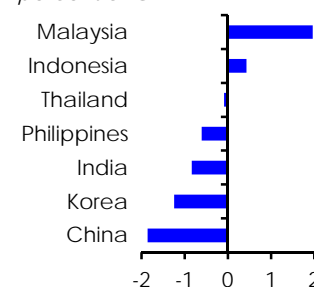
Most EM Asia currencies have appreciated in real effective terms since 2000, which has contributed to a decline in real net exports as a percent of GDP with few exceptions such as Malaysia (Charts 19&20). Conversely, EM exports by most

Chart 19
Real Effective Exchange Rates
% change; Jan 2000-Dec 2015



Source: BIS, IIF.

Chart 20
Effect of REER Movements on Real Net Exports
percent of GDP



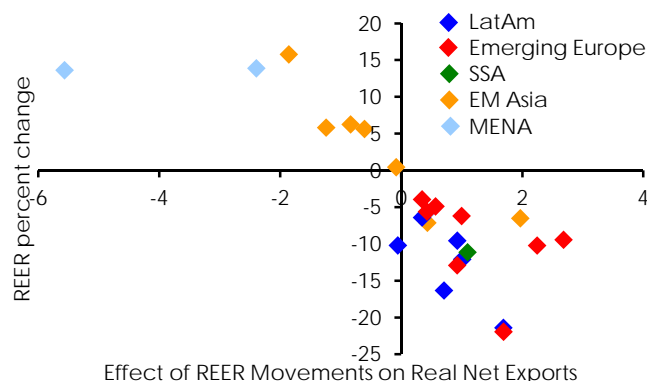
Source: IMF. Jan 2013 to Jun 2015.

other regions have benefitted from real effective depreciations of their countries' currencies over this period (Chart 21).

The last 18 months have seen depreciation of Asian currencies, but we do not expect this to drive any rebound in Asian exports. Even after the recent across-the-board nominal weakness in Asian currencies, Asian export competitiveness has deteriorated overall compared to other emerging markets regions. In the past, Asian exports have usually recovered before other emerging markets regions and by the strongest degree. However, it is unlikely to be the case this time around as the global supply chain has been disrupted by both China and the U.S. We expect some countries with cheaper currencies, very competitive labor costs and geographic proximity to the United States and the Euro Area, such as Mexico and Central and Eastern Europe, to take the lead in a potential recovery in global trade—if any.

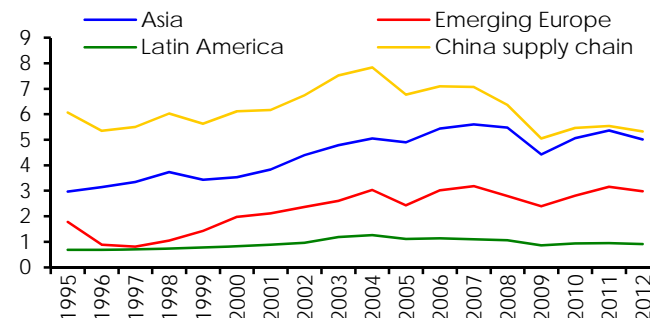
In the longer term, Asia should increasingly focus on diversifying its merchandise exports base to promote more horizontal intraregional trade. Intraregional trade integration in Asia is somewhat higher than in other emerging markets countries such as Latin America or Eastern Europe (Chart 22) but seems to be mostly driven by vertical intraregional trade ("China supply chain") rather than genuine horizontal intraregional trade. Export similarity is still quite high with few exceptions such as Philippines, India and Indonesia (Chart 23). Some recent policies have been heading in the right direction with increased emphasis on dismantlement of import tariffs and bilateral agreements, but progress has been overall too slow to mitigate the impact of a rapidly slowing China.

Chart 21
Effect of REER Movements on Real Net Exports
percent of GDP (x-axis); percent change (y-axis)



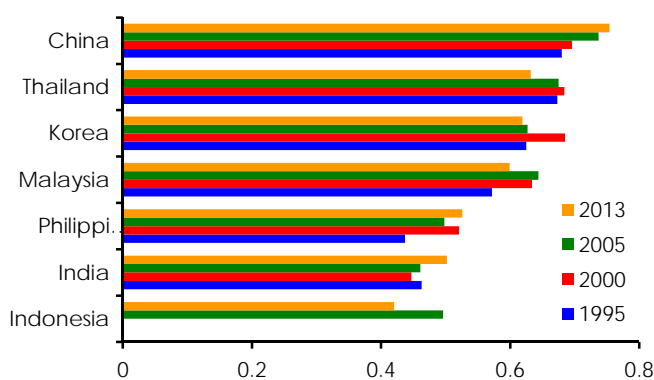
Source: IMF, BIS, IIF. January 2013 to June 2015.

Chart 22
Intraregional Trade Intensity
percent of GDP



Source: IMF. For each region, based on the sum of trade intensity of economies in that region with each other. China supply chain includes China, Korea, Malaysia, the Philippines, Taiwan Province of China, and Thailand.

Chart 23
Merchandise Export Similarity with Asia*
index; closer to 1 = greater similarity of export structure



Source: UNCTAD. *Eastern, Southern and South-Eastern Asia.

APPENDIX

Chart A1
India: Merchandise Exports
percent of total

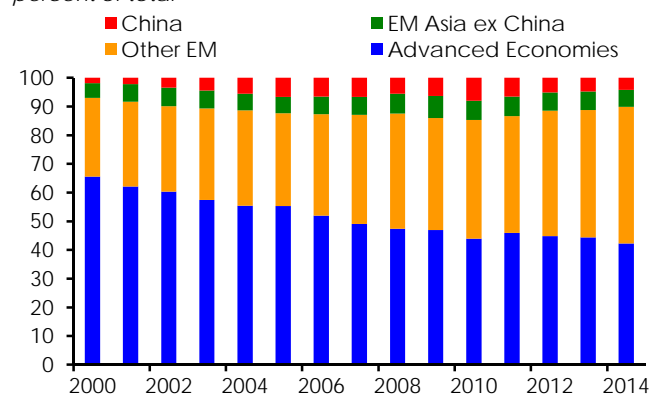


Chart A2
Indonesia: Merchandise Exports
percent of total

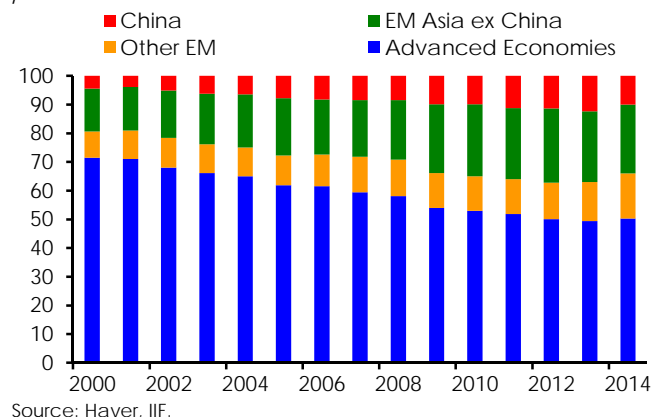


Chart A3
Korea: Merchandise Exports
percent of total

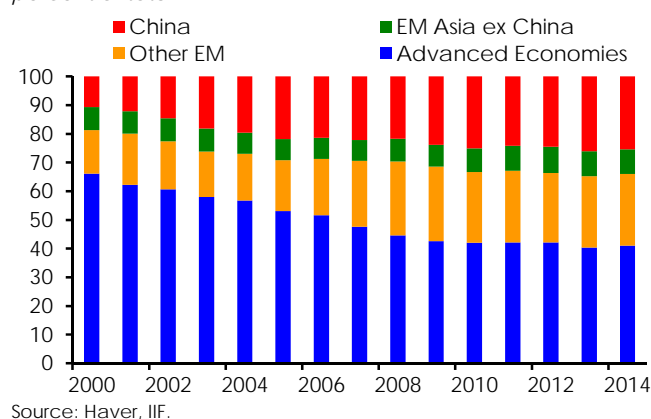


Chart A4
Malaysia: Merchandise Exports
percent of total

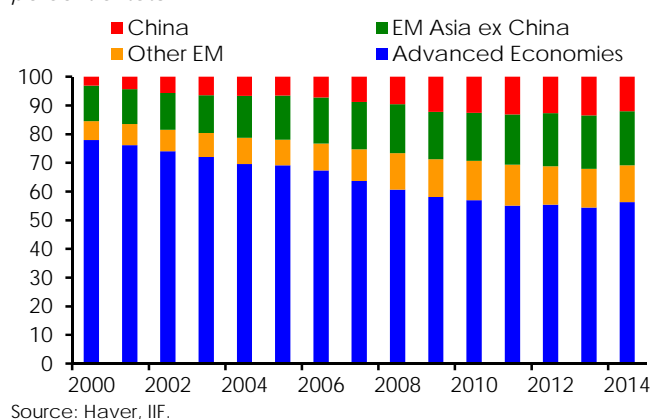


Chart A5
Philippines: Merchandise Exports
percent of total

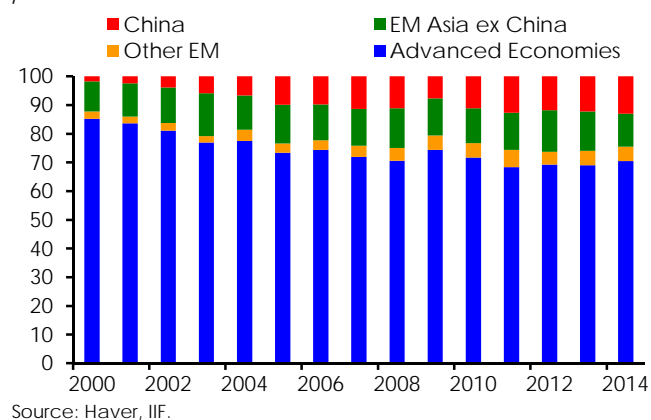
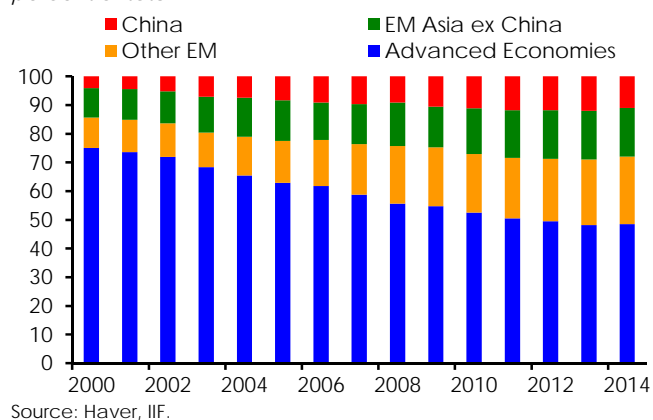


Chart A6
Thailand: Merchandise Exports
percent of total



APPENDIX

Chart A7

India: Merchandise Exports

percent change oya, 3mma

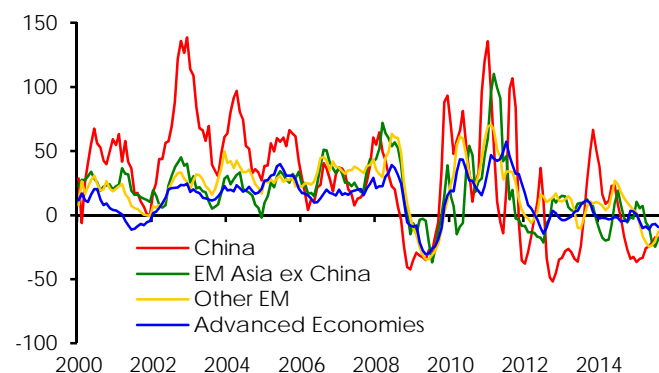


Chart A8

Indonesia: Merchandise Exports

percent change oya, 3mma

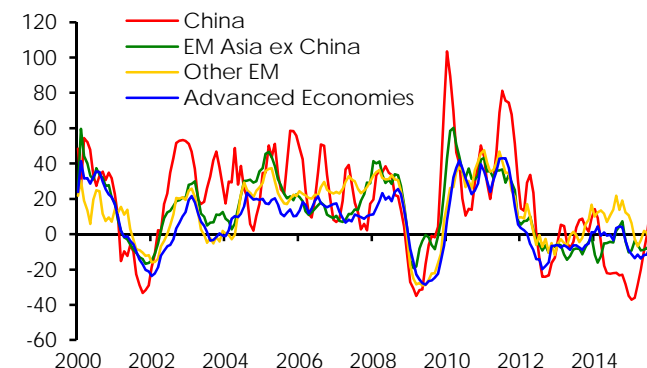


Chart A9

Korea: Merchandise Exports

percent change oya, 3mma

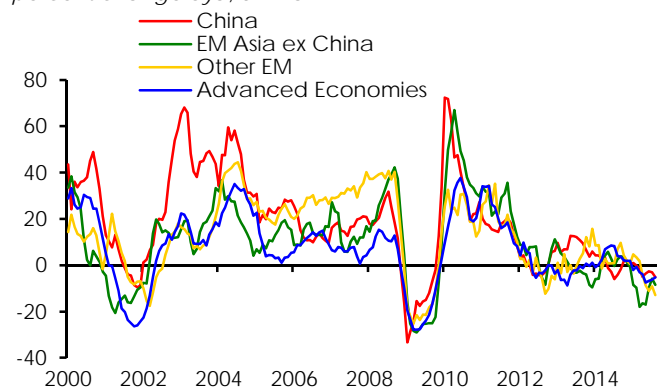


Chart A10

Malaysia: Merchandise Exports

percent change oya, 3mma

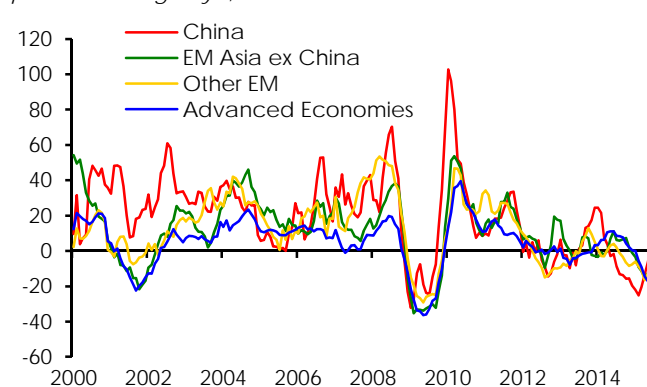


Chart A11

Philippines: Merchandise Exports

percent change oya, 3mma

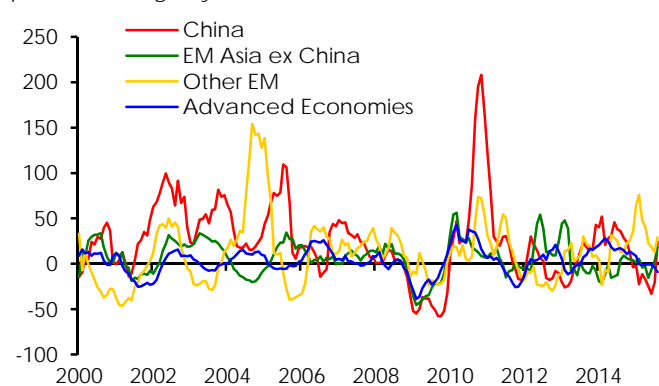


Chart A12

Thailand: Merchandise Exports

percent change oya, 3mma

