ECONOMICS: ASIAN PERSPECTIVES

ASIA'S SLOWING POTENTIAL GROWTH IMPLIES NARROWER OUTPUT GAP

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Many Asian economies have seen their growth rates slow toward, or below, their potential growth rates in recent years. Moreover, the potential growth rates themselves have also slowed owing to changes in demographics, investment trends and productivity growth. As a result, investors should be braced for surprises, for instance, in monetary policy or the relative value of currencies in the region.

Slower Potential Growth Rates

Asian economies have been in a cyclical slowdown over the past few quarters. Moderating core inflation, which implies a negative gap between the current growth rate and the potential growth rate—or "output gap"—has prompted central banks to resume monetary easing.

At the same time, however, the potential growth rate could also be declining owing to structural factors such as slower growth in the working-age population in many of those countries. These factors have prompted us to reassess the output gap, inflation risks, and appropriate monetary policy settings across the region.

Our assessment of each country's potential growth is based on the "production function approach," which looks at the three major inputs for economic expansion: labor supply, growth in capital stock and total-factor productivity (TFP).

Overall, compared with the previous two normal economic cycles before and after the global recession, we expect South Korea, Thailand and Singapore to see the sharpest declines in potential growth in the coming years (*Display 1*). Malaysia, Indonesia, the Philippines and India are likely hold up relatively well. China should remain the fastest growing economy in Asia, with its "new normal" trend growth of around 6.7% increasingly recognized by the market.

Demographics Drag Doesn't Apply to All

In terms of labor supply, countries that are likely to experience sharper declines in potential growth tend to be the same ones that—according to the United Nations projections—are expected to see a noticeable deceleration in working-age (15–65 years old) population growth (*Display 2*). In the rest of the region, the demographics drag is not as severe as generally perceived. In Indonesia, Malaysia, the Philippines and India, favorable demographics trends should continue to support growth.

Investment to Remain Stable

Growth in capital stock, as implied by the current investment ratio, is likely to remain largely stable in the coming years, barring any additional changes in structural growth drivers. This assumption is backed by sustained savings-and-investment balances, which are reflected in stable current account surpluses in recent years.

Display 1
Potential Growth Rates Have Moderated

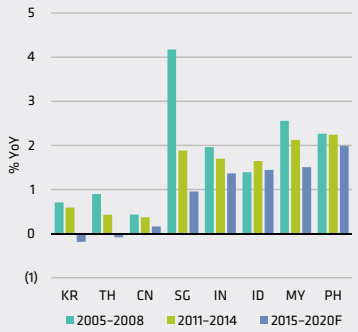
GDP Growth* (Percent)

	2005–2008	2011–2014	2015–2020F
CN	11.9	8.0	6.7
ID	5.9	5.7	6.2
IN	8.0	6.5	6.0
KR	4.3	3.0	2.5
MY	5.5	5.4	5.2
PH	5.2	5.9	6.0
SG	6.8	4.2	3.3
TH	4.3	2.5	3.3

As of August 6, 2015
*2015–2020 estimates based on production function
CN=China, ID=Indonesia, IN=India, KR=South Korea, MY=Malaysia, PH=Philippines, SG=Singapore and TH=Thailand
Source: CEIC Data and AB

Display 2
Demographic Headwinds Ahead

Average Annual Change in Age 15–65 Population



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Source: United Nations and AB

An exception is Malaysia, where a sharp increase in the leverage of the economy after the global financial crisis may result in restrained investments. Thailand's potential growth estimate is unspectacular, even though prospects of an upswing in investments for a planned large-scale transport infrastructure development are already factored in.

Productivity Holds Key

TFP growth, the third element of the potential growth rate, remains highly uncertain and has been subject to much debate. It depends heavily on technological advancements, global trade dynamics, productive investments and improvements in institutional efficiency.

Looking back at the past, TFP for Asian exporters was boosted by the globalization of supply chains before the 2008 Lehman Brothers crisis. Some northeast Asian exporters, in particular, benefited from exceptional growth in the smartphone and tablet markets.

Looking ahead, however, potential catalysts for further trade growth seem scarce unless there is further global cross-border division of production; a further ascent of Asian exporters in the global supply chain; or a technological breakthrough that ignites a major global demand cycle. Plateauing trade flows in the region suggest that TFP growth may moderate from its past heights (see "Export Outlook Clouded by Plateauing Electronics Cycle" *Asian Perspectives*, July 24, 2015).

In our conservative assumption (*Display 3*), we expect a continued moderation in TFP growth in the more mature economies such as Singapore and South Korea. In Southeast Asia, TFP growth has been stable over the past several years as exporters were not direct beneficiaries of the smartphone boom, but also this means that those countries may not be subject to as much drop-off. Meanwhile, China has been capturing a greater share of exports in value-added terms in recent years and has also consolidated its supply chains onshore. Its move up the value chain should help to sustain solid TFP growth.

Output-Gap Worries Overdone?

In countries where potential growth is declining more noticeably, the negative output gap could end up being shallower than generally expected. In fact, actual growth during the recent four quarters has been close to the potential rates in China, South Korea, Malaysia and the Philippines (*Display 4*). And even though Thailand is still growing below the potential levels, the gap is much smaller than its historical levels or what the market would expect in a normal recovery cycle. In contrast, negative output gaps in Indonesia and Singapore remain wide.

Narrower negative output gaps suggest that a demand-pull inflation could come sooner than expected, once the region's economies are back in a recovery cycle. That also implies that there is less room for policy leeway or need for monetary easing than is generally perceived in the market.

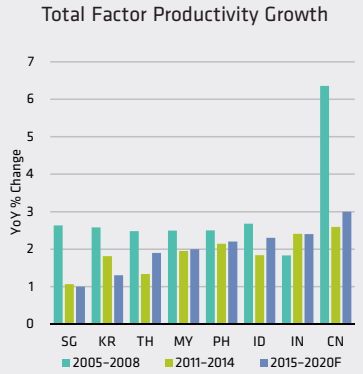
By the same token, valuations of local bonds may look less rich in the light of the lower potential growth estimations. Even so, investors should keep in mind that there's a risk that policymakers who fail to recognize the lower trend growth in a timely manner may overreact to a disappointing GDP number.

Is REER Consistent with TFP Growth?

According to the Balassa–Samuelson hypothesis, countries with greater TFP growth should see a faster appreciation in their real effective exchange rates (REER). In our evaluation of potential currency misalignments, this was generally the case for Singapore, South Korea, the Philippines and China over the past several years (*Display 5*). Meanwhile, the Thai baht REER has appreciated less than implied by TFP growth, while Indonesia, India and Malaysia have seen their REERs depreciate. There is a similar pattern of deviation for these three currencies in nominal effective exchange rate (NEER) terms as well.

Cyclical and external factors leading to such a decoupling of the TFP and REER trends include political instability and weaker current account dynamics. Such deviation implies that these countries have gained competitiveness, which is positive for exports and growth prospects.

Display 3
Productivity Growth Moderates in Maturing Economies



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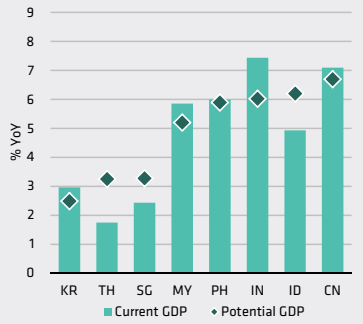
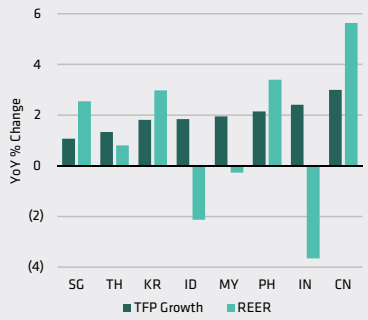
Source: CEIC Data and AB

Display 4
How Wide Is the Output Gap?



As of August 6, 2015
Actual growth in past four quarters and estimated potential growth for 2015–2020
Source: CEIC Data and AB

Display 5
Any Currency Misalignments?



As of August 6, 2015
Source: Bank for International Settlements and AB