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Asian domestic demand won’t make up for global slack

By Henny Sender

On the morning of August 9, the day after markets in Europe and the US collapsed, the Hong Kong government agreed to sell a plot of land at the minimum asking price to the sole bidding group that bothered to show up. For a property market that has seen prices rising 80 per cent in the past 30 months, the results sent a frisson of shock through the territory. That same day, the Hang Seng stock index dropped 5.7 per cent.

Several days later, Kevin Lai, the local economist for Daiwa Capital Markets, noted that with a 0.5 per cent seasonally adjusted contraction over the second quarter, Hong Kong – the most externally driven economy in the region – is now “halfway into recession”.

Of course, the Hong Kong market always drops more because it is liquid and foreign investors in Asia sell what they can, not just what they wish. But suddenly, the fundamentals have shifted as well.

The plunge in the South Korean market was even more dramatic and across the board, hitting everything from Korea’s (generally unimpressive) banks to its awesome technology companies, for the same combination of fundamental and technical reasons. The plunge reflected the fact that South Korea is a proxy for global growth in trade.

It was not supposed to be like that. Asia had begun to believe it was different – immune to the disease of low growth and deflation that is threatening the developed markets of the west and Japan (which has never been considered part of Asia anyhow).

The most surprising fact about the contagion was that it caught Asia by surprise, marking the end of complacency about the extent to which the region has decoupled from the rest of the world. Before August 9, most of the region seemed to believe that globalisation could only work one way – to its benefit. The orders would only flow in, trending ever higher, the global capital flows would only gravitate to Asia, never move in the opposite direction.

To be sure, Asia in 2011 is quite different from the Asia of 1997 and 1998. Government finances are in far better shape (hence the complacency with which Asia regarded the rest of the world) with many sovereigns (led by Indonesia) anticipating upgrades. While the loan-to-deposit ratios at banks may have risen, they are far healthier than their peers in the west.

Corporate balance sheets are far less stressed than they were at that time. There are not the massive mismatches of say big foreign currency borrowing against far smaller local currency revenues that were a feature of the Asian financial crisis. And, most importantly, in contrast to the rest of the world where wages and income have been flat or negative for some years, income is rising in the region.

But that does not mean that domestic demand in Asia is near ready to compensate for the shortfall of growth from the US and Europe and the plunging risk appetite of global investors.

The optimism is especially misplaced when it comes to China – at least for now. China is trying to foster a growth model built on domestic demand rather than exports. Its neighbour, Japan, offers a stark cautionary tale in the dangers of relying only on exports as the catalyst for growth.

The willingness of the Chinese government to let its currency appreciate at a slightly swifter pace is evidence of its commitment to that goal. Income and wages have been increasing at a rapid rate and retail sales continue to grow at a high double-digit pace. But that is not enough in an economy that is still less than half the size of the US. Meanwhile, credit growth has been reined in, with the growth in outstanding credit now at about 15 per cent. Property and construction peaked late last year and contracted in the first quarter, according to data from UBS. That suggests domestic demand could even weaken from here.

China adopted an aggressive fiscal stimulus policy even before the Lehman implosion in September, 2008.

It can still afford to do so. Government revenues are quite healthy these days, up more than 30 per cent for the first half. Government debt to gross domestic product is low (though the problem loans of the big banks should probably be included in the calculus). But China needs to wean itself off its dependence on fixed-asset investment.

So 10 days after the August 9, the talk in Hong Kong is dominated by concerns about growth rather than fears of inflation.

In coming months, the authorities will probably allow more exchange rate appreciation and policies will continue to encourage rising wages and other measures to foster homegrown demand.

Maybe the next time western economies stall, domestic demand from Asia will pick up the slack. But not yet.

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