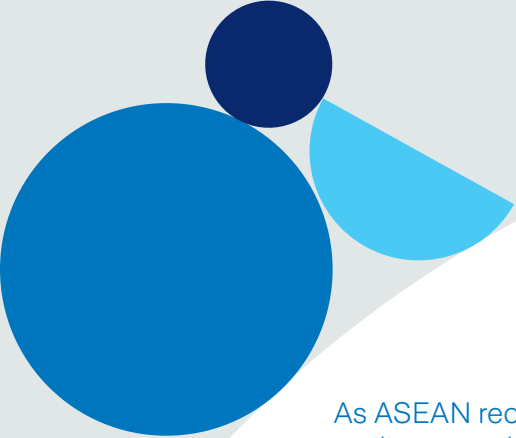


ASEAN Reboots

Key themes as
Covid is contained





As ASEAN reopens, economic activity has rebounded swiftly. It shows the region's resilience and efficiency despite severe Covid disruptions. While ASEAN reboots, several challenges have arisen, including China's recent slowdown and more hawkish global central banks. However, ASEAN's positive economic fundamentals and the vigour of global growth should help the region cope well with rising external uncertainties.

The silver lining

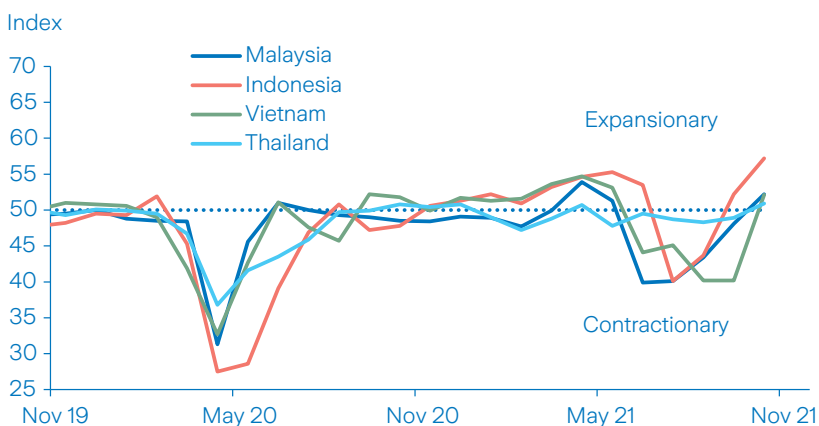
Instead of a V-shaped recovery as initially hoped, ASEAN's growth followed a W-shaped trajectory as Delta, a virulent strain of Covid-19, rampaged across the region, forcing sudden, severe, and extended lockdowns.

After a quarter with draconian containment measures, new cases finally receded while vaccine rollouts have gained significant traction. Factories, shops, and

restaurants are being allowed to reopen with operating levels moving towards 70-80% of pre-Covid levels as suggested by Google Mobility data and opening plans published by various governments.

According to Malaysia's government website, major states are now in stage four of the National Recovery Plan, which means most factories are running at full capacity with health protocols in place.

Manufacturing PMIs in major ASEAN countries improve swiftly



Source: Bloomberg

Encouraging vaccination progress, but more needs to be done

According to vaccine data trackers provided by Oxford University, Singapore and Malaysia have fully vaccinated between 75-85% of their population. However, many ASEAN countries still lag at a national level. On the bright side, the majority of people in large capital cities such as Jakarta, Ho Chi Minh, and Bangkok have received at least the first dose, based on data published by the governments and various announcements by the local authorities.

ASEAN is progressing towards fully vaccinating 70% of its population in H1 2022. With still low vaccination rates, risks of renewed outbreaks remain imminent. After a reduction in cases in recent weeks, Vietnam is now seeing these begin to rise again.

However, we suspect the bar for future draconian lockdowns is high, given the enormous economic consequences and limited resources to provide further fiscal stimulus. Moreover, there has been a mentality shift from zero Covid tolerance to 'living with the virus' by governments.

It will take time for supply chain disruptions to dissipate

ASEAN plays an integral role in global supply chains. Malaysia and Thailand are among key chip producers for the auto industry. Also, Vietnam is among the leading exporters of apparel, computer chips and mobile devices. Global conglomerates, including Samsung and Toyota, have large production lines in ASEAN. Consequently, factory closures and production cuts in the region caused a chain reaction throughout global supply channels.



Image source:
iStock

Signs of a rapid recovery in production post-lockdown, with Manufacturing PMIs rising sharply in September and October in major ASEAN countries, have demonstrated the resilience and efficiency of ASEAN's manufacturing sector. Yet, we think the production jams will take time to ease. Three factors are behind this assumption.

First, a record rise in order backlogs during the lockdowns means factories will need to fill those before working on new orders. Current exuberant global demand, amplified by the holiday season, will stress factories as they ramp up production. Yet, it takes time to bring operational levels back to 100%, while some disruptions due to Covid persist.

Second, labour shortages are causing trouble. Virus fears and lockdown fatigue led hundreds of thousands of Vietnamese workers to go back to their villages. Many of them still show reluctance to return to factories, as just reported in the New York Times. In Malaysia, border closures have made it difficult to find staff, given that foreign workers are among the key sources of industrial labour, as reported in the Straits Times last month.

Third, surges in commodity prices and material shortages continue to pose challenges for the sourcing process. The input price components of the Manufacturing PMIs are still hovering at elevated levels.

Overall, these elements appear to be transitory, but they are likely to delay the supply chain recovery. It remains uncertain how long disruptions will last. We suspect disruptions might take two to three quarters to diminish. Much still depends on whether Covid is well-contained.

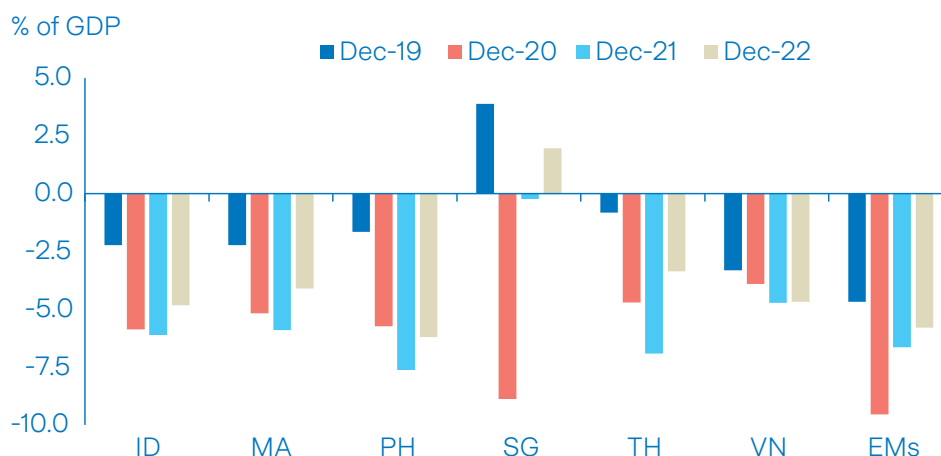
The export blessing

Empty shelves in shopping centres from the East to the West when Christmas, New Year and Chinese New Year are approaching mean demand for ASEAN's goods should stay inflated well into next year. Supply shortages and the strength of global demand have lifted the prices of commodities such as coal, natural gas, nickel, and palm oil to multi-year highs.

In recent months, trade surpluses of commodity exporters, including Malaysia and Indonesia, have reached record levels. While commodity prices have started to ease, they remain elevated by historical standards. This ongoing trend means trade surpluses for those exporters will remain favourable, although they might have peaked.

On the tech front, the recovery in semiconductor production appears well underway. Tech exports should play catch up in the next few months, benefiting semiconductor producers like Vietnam, Thailand, and Malaysia. For example, Malaysia's chip production is likely to ramp up to close the supply gap. Vietnam should see robust rebounds given how lacklustre activity was amid the lockdowns in Q3. However, as new cases in Vietnam have risen again recently, Covid remains the key risk to this outlook.

Fiscal deficits are likely to have peaked



Source: IMF; 2021 and 2022 budget deficits are forecasts

China is slowing down. How will it impact ASEAN?

Global shifts of supply chains and production away from China to neighbouring countries mean ASEAN is potentially the largest beneficiary. For example, FDI flows (excluding China's investment) into Malaysia and Indonesia have been very supportive this year, suggested by latest FDI data published by Malaysia's Ministry of International Trade and Industry and Indonesia's Ministry of Investment.

However, there are more nuances to this narrative. According to the WTO, ASEAN imported around 20-30% of merchandise from China and exported between 10-15% of goods to China in 2020. The linkage between ASEAN and China has been an essential part of regional supply chains as a whole. Therefore, any disruptions in China will have spillover effects on ASEAN.

In the last decade, China has been among the top investors in ASEAN according to the 2020-2021 ASEAN Investment Report by the UNCTAD. Also, China is one of the largest importers of coal, iron ore and steel from ASEAN as trade data suggest. Therefore, China's structural slowdown, its pivot away from the investment-led growth model, as well as its recent property downturn, will adversely affect demand for ASEAN's goods and weigh on regional trend growth over time.

Central banks to exit debt monetisation?

According to the IMF, ASEAN's fiscal deficits were between 6-7% of GDP in 2020, except for Singapore. Notably, central banks in Indonesia and the Philippines have directly financed public debt.

Bank Indonesia (BI) and Bangko Sentral ng Pilipinas (BSP) have not yet stepped down from their debt monetisation in 2021. Recently, BI announced it would buy at least IDR 575trn (3.4% of GDP) of government bonds over 2021 and 2022. More than 80% of the purchase will be in the primary market.

In the Philippines, BSP's government bond holdings increased by around 400% between early 2020 and June 2021 to PHP 1.52trn (Bloomberg, August 2021) with a sizable amount of direct financing of government debt. We estimate BSP's government bond holdings have risen from around 5% to 15% of total government bonds outstanding between 2019 and mid-2021.

So far, markets have been supportive of the central banks' unconventional policy given the difficulty in raising funds during the pandemic by the governments. However, it can be a slippery slope if BI and BSP keep pushing the timeline to exit from the intended one-off monetary measures.

A positive sign is that governments are planning to bring down fiscal deficits through fiscal consolidation and modest tax hikes in the coming years according to the recently released 2022 budgets. It shows the commitments of these governments to maintain fiscal discipline and financial stability.

How will ASEAN cope with tightening global financial conditions?

In 2013, when the Fed tightened its policy, the region experienced large capital outflows and currency depreciation as part of the 'taper tantrum'. Will it be different this time?

We think a short-lived episode of volatility might be unavoidable when the Fed's rate hikes come through next year. However, we believe ASEAN will be able to weather the headwind this time. There are three factors to be considered.

First, levels of foreign capital in ASEAN have reached multi-year lows in the last two years. ASEAN's recovery has lagged other developed markets (DMs) as Covid resurged, making the comeback of offshore investors rather underwhelming. With low levels of foreign capital, ASEAN becomes less exposed to external financial conditions.

Second, while global monetary conditions are tightening, levels of liquidity remain abundant. ASEAN's rates still provide attractive yield differentials despite a potential slower process of policy rate hikes by ASEAN's central banks compared to the Fed.

Third, major ASEAN countries are running current account surpluses and have built up stronger FX reserves except for Thailand, according to data published by regional central banks. These will help balance capital flow vulnerabilities and potential currency depreciation.

Conclusion

Despite rising external uncertainties, ASEAN is well-positioned for a decent recovery ahead. As economic activity has rebounded swiftly within a short period of the reopening, ASEAN proves to be a region of resilience and efficiency. Furthermore, the vigour of global growth should pave the way for ASEAN to reboot. Critical risks are low vaccination rates in some countries, making them more vulnerable to future virus outbreaks. Hence, vaccination rollouts should remain the top priority for the region.

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