

Good MornING Asia - 26 May 2020

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By Robert Carnell



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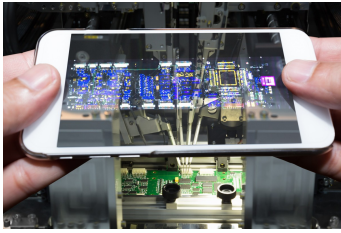
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EM Space: Upbeat mood on reopening held in check by simmering US-China tension

- **General Asia:** Economies continued to gradually ease restrictions with Japan lifting its state of emergency and with US states and select European countries allowing more sectors to reopen for business. Meanwhile, US-China tensions continued to simmer with China denouncing a recent move by the US to blacklist certain Chinese entities as tension between the two countries remain elevated. For the week, regional players (Singapore and Taiwan) report growth numbers while the US data calendar features GDP, initial jobless claims and consumer confidence.
- **Singapore:** Just released, the revised estimate for 1Q20 GDP put growth at -0.7% YoY, up from the -2.2% first estimate. As expected, manufacturing was a source of upward revision after a strong bounce in output in March, lifting quarterly growth to +6.6% from -0.5%.
- **Singapore:** April CPI inflation and industrial production data this afternoon will provide a glimpse into where GDP growth is headed in 2Q. The consensus is -0.5% YoY for inflation and -1.0% for IP. We expect worse readings than consensus. The government has just cut its full-year 2020 GDP view to as much as a 7% fall from the previous 4% fall and is set to unveil a fourth stimulus package later today.
- **Philippines:** Bangko Sentral ng Pilipinas (BSP) Governor Diokno signalled another round of

easing is in the works as he hinted at further rate cuts due to subdued inflation. Diokno ruled out the use of negative interest rates and further reductions to the reserve requirement for the time being. We are pencilling in a 25 bps policy rate cut at the June meeting with monetary authorities giving the economy a boost as the government slowly removes restrictions after almost 3 months of lockdown.

What to look out for: Covid-19 developments

- Philippines budget balance (26 May)
- Indonesia consumer confidence (26 May)
- Singapore GDP, inflation and industrial production (26 May)
- US new home sales and consumer confidence (26 May)
- Philippines remittances (27 May)
- Taiwan GDP (28 May)
- US GDP, initial jobless claims, durable goods orders (28 May)
- Thailand trade (29 May)
- US core PCE, consumer sentiment and whole sale inventories (29 May)
- Philippines bank lending (29 May)
- Fed Powell speech (29 May)

Asia FX Talking: Slow, but not steady

Market sentiment has improved, but like the pandemic, progress is not steady, and remains slow and vulnerable to shocks



Source: Shutterstock

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Stagflation is not the logical consequence of this pandemic

Interrupted supply, a recovery in demand, cheap money and lots and lots of debt. Sounds like a recipe for stagflation, and this is certainly the theme of...



Low growth and high inflation were common in the 1970s

What is stagflation?

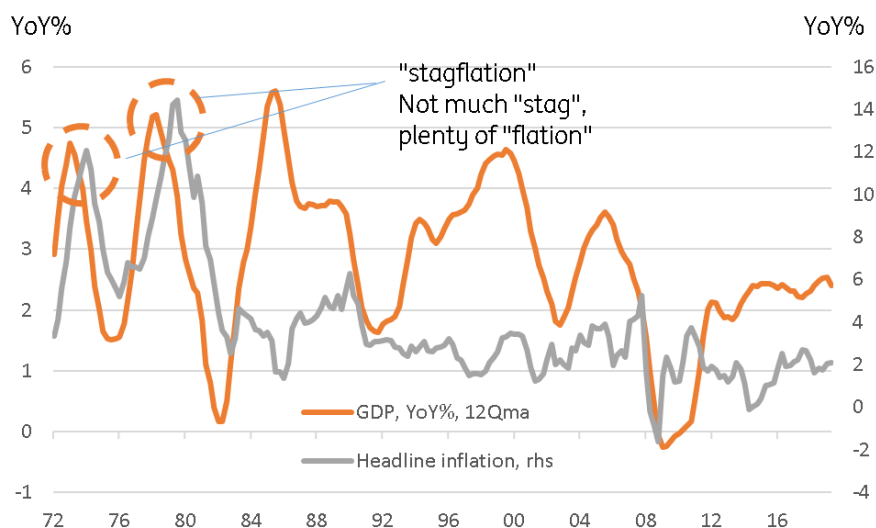
Stagflation is a combination of very weak or potentially even negative economic growth, coupled with rapidly and persistently rising prices. It was last seen in developed markets in the 1970s in conjunction with rising oil prices thanks to an OPEC-driven crude shortage and the accommodative stance of central banks.

At the time, it was regarded as a terrible outcome. Households saw the value of their savings reduced by high inflation - though this was typically measured in high single or low double digits - and not the hyperinflation of the 1930s. Using the United States as a benchmark (their experience was echoed in Europe), inflation hit peaks of about 12.5% in 1974 and then 15% in 1980.

What is most notable about growth in this period is that it was not particularly weak by today's standards. Though the eventual tightening that followed high inflation did lead to recessions in 1975 and between 1980 and 1982, as accommodation was eventually followed by restraint. The

inter-recessionary periods saw strong growth, often in excess of 6%. Smoothing the business cycle with 12-quarter moving averages, growth was clearly more volatile than it has been in recent years, but it was still closer to 3% on average outside the recessions than the modern-day equivalent, which is closer to 2.0%.

It has been a long time since inflation responded to strong growth



Source: CEIC
Stagflation

A little inflation would be great, if we could get it

You might argue therefore that a bit of 70s style stagflation might be a decent trade-off for what we have now. Growth will eventually recover from the Covid-19 outbreak and associated lockdowns, and with plentiful bottlenecks in supply, some price spikes are highly probable when this happens. What is needed then for stagflation is for wages to increase, leading to an upward spiral in prices, as firms raise prices again to maintain margins. It has even been suggested by some that letting inflation rise to 4% for a decade or so, could undo much of the debt build-up that is taking place during this pandemic.

And yes, a bit of higher inflation would certainly help deflate away this debt if it could be created. We might also note the recent pick up from very low levels of benchmark prices of crude oil at the behest of OPEC supply constraints. All the ingredients seem to be falling into place, don't they?

But just as a cake will not miraculously spring from a bowl of flour, sugar and eggs without some means to bake it, stagflation requires a mechanism to allow wages to push higher in the face of rising prices and embed them into accelerating prices. At its heart, stagflation requires a wage-cost push spiral to happen. For most of the world, the mechanisms that once allowed this to occur simply do not exist anymore and will probably never do so again.

No mechanism = no stagflation - simple

There is no single factor here that is critical, but the following are all reasons why that wage-cost push mechanism is no longer in play, and unlikely to return in our lifetimes.

- Falling unionisation / collective bargaining
- Decreasing manufacturing/rise in the service sector
- A decrease in firm-specific skills
- Increase in labour alternatives (roboticisation/automation)

Could we see some bounce back in inflation from a reversal of globalisation? Prior to the pandemic, globalisation would also have been another factor in the list above.

And yes, post-Covid-19, some rethink of supply chains is likely. But we are probably talking about more redundancy being built into them, rather than an outright return to autarky. So the degree of the shift may be quite minor.

That said, we would certainly concede that the disinflationary impetus from ongoing globalisation might lessen or even reverse for a time. But on its own, it's not enough, and we would still be missing the mechanism that takes rising prices, say due to a supply bottleneck, and then embeds them in faster wages growth, resulting in a squeeze in margins, and a further increase in prices and so on.

This deglobalisation/supply chain story is, in our view, about the only conceivable scenario in which we might see prices rising for long enough, and on a broad enough front to become embedded in price-setting behaviour. And even then, it is hard to see this affecting wage setting, so ultimately, its main effect will be to weigh on real purchasing power and activity. More likely, pockets of higher inflation will spring up where supply constraints are greatest but be dominated by the much weaker demand environment elsewhere.

Indeed, the persistence of large output gaps in much of the developed world following the global financial crisis could be another reason to downplay inflation risks following the pandemic. That said, the link between inflation and economic activity seems particularly weak, and unless the impact is asymmetric (which is a plausible and interesting thesis, but one that is beyond the scope of this article), then for balance, we probably shouldn't make too much of this as an additional argument for inflation remaining low. We don't believe it's a necessary condition in any case.

Stagflation - not quite the horror story that is suggested

Stagflation, despite the bad name it got in the 1970s, enabled my parents and many others to buy a house they couldn't really afford and to pay down its mortgage. Because even though they were paying high mortgage interest rates, they also saw their wages rise at percentages that meant that their stock of debt to incomes ratio quickly dwindled. Before long, that left more money for other things. At least, until the 1980s, where monetarism and wage restraint (often through the public sector) came into vogue, delivering recession as it cured the earlier inflation excesses.

So when I read yet another article warning of the dangers of stagflation, ([for FT subscribers, this from Stephen Roach is a good example](#)) I'd like to remind the authors that in the current environment, with debt ratios hitting previously unimaginable highs, it could be an outcome to grab with both hands, not to recoil from in horror.

Stagflation is not a "when?", it's a "how?"

And like the article that suggested running inflation at 4%, just like those that suggest central banks run economies "a little hot," the key unanswered question is a blisteringly simple

one, “how?”

These same central banks have presided over economies with unprecedentedly tight labour markets, running monetary policy in a more accommodative way than at any time in history. And still, they have mostly not even managed to get inflation to reach the mid-point of their inflation targets except for temporary oil-price induced flurries in the headline rate. Let’s be very clear, if they couldn’t get inflation to 2% then, they certainly aren’t going to be able to achieve 3% or 4% now.

Without the mechanisms to embed rising prices into a wage-cost-push inflation spiral, and with monetary policy impotent to create demand-pull inflation, this higher inflation, whether accompanied by low growth or not, simply isn’t going to happen. And all the navel-gazing and quasi-academic consternation about inflation expectations becoming “unanchored” count for nothing if inflation just cannot gain a toe hold in the modern economy.

High debt is a problem, stagflation is not the obvious answer

I do tend to agree with some of the comments by those writing such articles that getting debt to “disappear” will be an important pre-requisite for re-invigorating growth following this pandemic. How to achieve this is a question that we have some years to debate. But it is unlikely to be by deflating it away.

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China: What do the targets set by the National People's Congress mean?

China Premier Li Keqiang's government work report at the National People's Congress tells us more about how China is going to move on after...



Source: Shutterstock

What does the report mean for China and international economies?

Below are what we consider to be the highlights of the government work report, listed in the sequence of importance for the Chinese economy.

A lot of emphasis on job stability

Stabilising jobs is the top priority of the government, setting a GDP target is not.

The report highlighted many times that jobs are important to the economy this year. By repeating this objective, it's clear how critical the job market situation is.

The target for the jobless rate is around 6%, which is optimistic as global demand is sinking. This is especially true for factory workers.

So how can the government achieve this target when the current jobless rate is already at 6%?

The work report provides some hints. Higher education institutions are going to increase capacity by two million students this year. This could absorb new graduates from high schools to continue their education and allow others to do post-graduate degrees, which will reduce the number of people looking for jobs. But this may not help young factory workers who have been recently laid off. These workers are usually in the low-income group, they need a job not only for themselves but also for their families living in rural areas.

"Stabilising jobs is the top priority of the government, setting a GDP target is not. "

? Size of the fiscal stimulus

The amount of fiscal stimulus is uncertain but seems low compared to my estimate of between 6% and 8% of nominal GDP.

The work report stated a fiscal deficit of more than 3.6%, but it did not provide an upper limit. So it seems the government wants to be flexible on the stimulus amount.

Looking at the special government bond size of CNY3.75 trillion (+1.6 trillion from 2019) together with the special government bond of CNY 1 trillion, the stimulus is smaller than I had expected. However, the government can beef up the issuance of local government special bonds around August when the situation around the coronavirus becomes clearer. The government did increase this quota in June last year after the trade war escalated.

The report set a very strong tone on how the money should be spent.

- Fee and tax cuts, rental reduction, inducing consumption and investments.
- It cannot be used on the operation of local governments
- General government expenses have to be reduced

✓ Lower interest rates and innovative lending programme to keep companies afloat

The report, by emphasising job stability, stated that banks should lend to companies to keep them afloat. We expect the PBoC to lower interest rates and provide innovative policies to lend to SMEs.

✓ Advancing technology is the focus for long-term growth

The focus of growing technology is obvious and the report highlighted this as an important objective.

As we have mentioned, the New Infra scheme is now at the core of its long-term growth plan. Though this plan has been laid out by the government, it will be up to the private sector, i.e. the market to decide which areas will grow within the wide scope of technology.

To us, this signals that the technology war between China and the US has escalated. China is going to develop its own technological capacity so it won't be too dependent on the rest of the world.

? The section on trade is vague

As usual, there is a section on trade. But apart from “implementing the Phase 1 deal with the US” and building regional trade mechanisms, the description of trade is quite vague.

This may signal that China realises the difficulties faced by exporters this year, as global demand is weak.

✓ No growth target

No growth target has been set for 2020 and indeed, there was not a single word on GDP growth. This is what we expected.

Our view is that it is impossible to set a growth target at this uncertain time when the whole world has suffered from Covid-19 and global demand is very weak, which will have a serious impact on China's economic growth. The risks, however, are not all one way. If Covid-19 subsides quickly, and there is no second wave then global demand could recover faster than we expect and GDP growth in China could be better than our forecast of -1.5% for 2020.

There is another threat to China's growth, however, which is the technology war with other economies, especially the US. We believe this will hurt China's businesses even if Covid-19 subsides. Moreover, there is a chance of a second round in the trade war.

- So how can we gauge the performance of the government if there is no GDP growth target? We can gauge its performance by looking at industrial profits. The damage from Covid-19, the technology war and potential trade war are hurting the manufacturing sector more than the service sector in China. An improvement in industrial profits should be a barometer of how well the economy has managed these three risks.

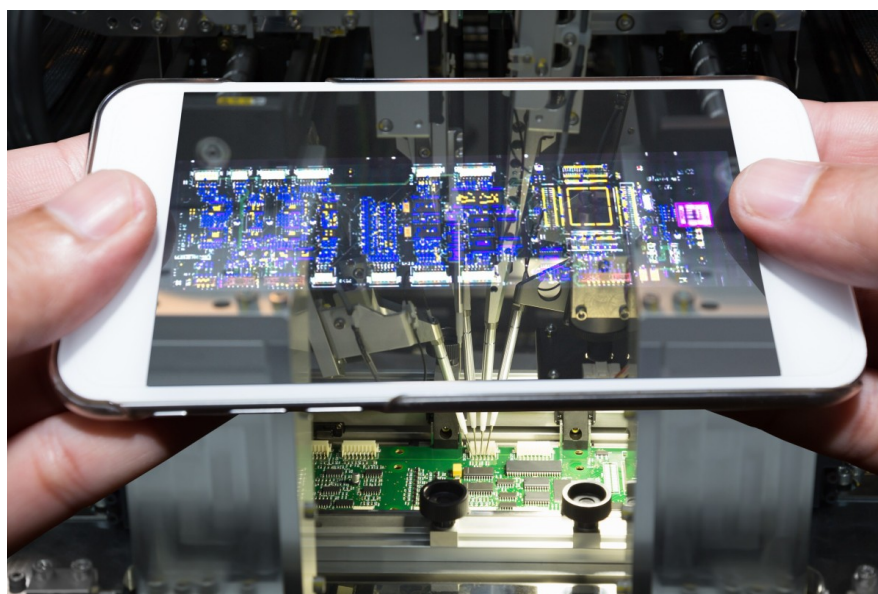
The work report changes our forecasts on China

We keep our GDP growth forecast at -1.5% for 2020, with a stimulus size of 6% to 8% of GDP unchanged because we believe the government will increase the size of the local government special bond around August.

But we revise our forecast on USD/CNY to reflect a slower pace of strengthening in the rest of 2020. Previously, we forecast USD/CNY at 6.90 by the end of 2020. This seems to be too optimistic from our reading of the report. We now see USD/CNY at 7.050 by the end of 2020.

Taiwan's industrial production caught in between US- China tensions

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Source: Shutterstock

Industrial production rose slower

Taiwan experienced a +3.5% year on year rise in industrial production in April from +10.41%YoY in March, which is mostly the result of a higher base effect. Integrated circuits increased by a considerable [32.27%YoY](#) due to 5G production, internet of things and cloud computing.

But the rising tensions between mainland China and the US could also affect Taiwan's industrial production for the remainder of 2020. Export orders reduced by 4.3%MoM in April but rose by a mere 2.3%YoY, which suggests that industrial production for the months ahead could be weak.

Below are two angles on how rising tension between mainland China and the US could affect Taiwan's manufacturing.



Taiwan could gain if the US imposes restrictions on companies supplying tech to China

If the US imposes restrictions on companies supplying technology to China, the market expects an overall negative sentiment and would be concerned about how Chinese technology companies would survive.

But [the media in Taiwan reacted differently today](#). There are Taiwanese technology companies, most of them in the semiconductor space unaffected by the US restrictions as their technologies and supplies don't come from the US.

And, sitting between the US and China, Taiwan's tech companies always have the option of supplying semiconductors to non-Chinese companies that could make up for the potential loss.

From this angle, Taiwan's semiconductor companies could gain from the China-US trade tensions.

⬇️ But Taiwan will suffer more if China triggers the unreliable entity list

But if China decides to retaliate, it is increasingly likely to start using the unreliable entity list mechanism - and prohibit Chinese companies from using US technology. This is likely to result in a sharp fall in demand for US technology products.

Those products have a global supply chain behind them, and Taiwan's tech companies are very important in that supply chain. For example, one Taiwan semiconductor company is preparing to build an advanced factory in the US.

The market will then expect the US to retaliate too creating a ripple effect, and this would inevitably cause massive disruption.

Taiwan will definitely suffer from that disruption, and this negative impact on Taiwan is much bigger than the positive impact we mentioned above.

Bumpy road ahead for Taiwan's manufacturing sector

Taiwan is a small open economy which specialises in semiconductors and relies heavily on both mainland China and the US.

Therefore, we believe Taiwan's manufacturing sector will face many challenges this year, and maybe even longer depending on the China-US trade tensions.

USD/TWD rose to 30.057 from 29.993 on 22 May due to the rising tensions. Our forecasts for USD/TWD is 29.7 by the end of 2020.

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