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The nagging Eurozone crisis and its implications

By Ranjan Chakravarty and Joseph Cherian (November 2011)

In an article written for the Straits Times on 8 July 2010, one of us identified that the immediate causes of the crisis in the Eurozone were overleveraging and overspending, and a period of belt tightening was to be expected in order for the European countries to emerge positively from this crisis. A year and a half later, it is clear to even the most casual observer that a coordinated supra national growth-oriented policy and debt restructuring program are essential for Europe to mend. However, no decisive move has been taken in this direction to date. Growth in the Eurozone is at 1.4%, which is the US's situation as well. As a consequence, our view is that both Europe and the US are going to be in the economic doldrums for the next year, and possibly further out.

How does this impact Asia? Given that most of Asia ex Japan is still recording robust growth rates, public and private savings rates continue to be high, and domestic consumption, investment and intra-regional trade continue to grow and drive the regional economies, we feel that Asia's vulnerability to any US or European slowdown will be limited and benign. If anything, the export-oriented manufacturing industries will take a hit due to reduced demand from the West. Even this impact would likely be felt in Korea and Taiwan, while the impact elsewhere would be localized, example, the coastal provinces of China. Another impact would be through tighter European and US credit, which would cause the flight of risk capital from Asia. This flight of FDI and portfolio capital back to their home countries is expected - capital redeployment will take place so as to repair default-affected bank balance sheets at home.

At a country level, China continues to lead the world with 9.1% growth and a debt to GDP ratio of 17.7%. China's real estate market is the main cause for worry as it continues to soften. Nevertheless, we are comforted in the knowledge that this is a managed process. China is working to ensure that there is no hard landing in the real estate sector, and the expectation is that housing prices will wind down gradually and in an orderly fashion through the coming year. A secondary concern is whether China has a genuine handle on its domestic debt problem, whose magnitude is hard to tell given there is less transparency on local government debt. Barring any such coincidental negative domestic property and debt surprises, we expect to only see a modest impact on China's overall growth from a European slowdown.

India on the other hand has taken a beating this year. Its currency has come off nearly 20% from its peak, and the RBI's aggressive rate hardening policy has affected growth substantially, bringing it to just below 7%. The impact has been especially felt in the Indian manufacturing sector, which has reported a Y-O-Y contraction of 5.1% in October. If food price inflation remains under check, we could expect easing on the cards, with growth picking up in 2012 and the currency paring its losses. However, we do not expect huge portfolio inflows to pick up for India this year.

Domestically, one major concern, especially in light of the government's recent property cooling measures, is the continued linking of Singapore's real estate prices to the Hong Kong property market, which in turn is greatly influenced by developments in China. Indeed, a major Hong Kong realty price correction, say due to a "hard landing" in China, will have a major effect on private investment properties in Singapore.

In summary, the impact on Asia, and specifically Singapore, from a European slowdown will be as follows. First, due to capital contraction in Europe, we expect European banks to cut back on retail and SME lending across the world, and certainly in Asia. This is due to the fact that this region has many 'high yielding' countries, many of whom are serviced out of Singapore. In Singapore, expect constrained lending by the foreign banks, though we see no reason for Singapore lenders to follow suit. In fact, we see this as an opportunity for domestic financial institutions to improve their market share and do well this coming year. Additionally, alternative providers of capital, say private equity funds, can step in and ease any credit crunch.

Second, we can expect the portfolio capital flight, which has already started, to continue in the short term given it is the knee-jerk response to any crisis. The weakening of India in the last year has also been a major additional driver of this flight. However, we feel that this capital will gradually return to the region, because a capital flight back home to the US or Europe today is not a flight to quality anymore. To the contrary, capital is constantly in need of sustainable growth, which the Western economies cannot provide in the current situation.

Singapore, which is a hub for east-west trade, will certainly be affected by any breaks in that trade. However, capital continually seeks risk-adjusted returns, and Asia as a region will continue to deliver on that count. Although there are still major questions about the sustainable long term economic transition of this region, the short to medium term situation continues to be promising, the Eurozone financial and economic crisis notwithstanding. Indeed, there is potential for Asia ex-Japan to turn into a safer growth haven for global capital than ever before, and for improved intra-Asia trade that is devoid of distortions and barriers. Both these realizations will benefit Singapore tremendously.

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