Tuesday, October 07, 2008

End of the line

Export growth to slow sub-5%

- China's export growth has remained surprisingly resilient. But not for much longer. New export orders have already started to soften. Export growth is forecast to fall sub-5%YoY in 2009.

- Net exports will drag on GDP growth as a result. Yet it's wrong to overplay the negative implications. Domestic demand, which explained 85% of GDP growth in 2007, is more important to the growth outlook. Indeed it is a correction in the residential property sector that represents the larger risk.

- The government will respond to slowing GDP growth by spurring domestic demand rather than weakening the currency. Stability remains the guiding principle of FX policy. The PBOC will tolerate gains against either the EUR or USD, making a more flexible EUR/USD the largest influence on the CNY's performance.

- How to predict the export outlook? First, focus on capital-intensive exports. The category is the most important driver of overall export growth. Labour-intensive exports have already softened, but mainly on structural changes in the economy itself. Second, focus on developing-world demand. This was a surprise source of strength in 2008. But global re-coupling will drag on demand in 2009.

- It's not all bad news. We think it unlikely that export growth will fall sub-0%YoY. In 2001, China captured significant US market share as worried consumers switched to cheaper, Chinese-made, alternatives. In 2009, China is expected to capture significant Euro area market share for the same reasons. Expect a widening in the Euro area's trade deficit versus China.

China's exports have defied gravity since the start of the year. Export growth has slowed modestly since 2007, but it is still running at an impressive 20%YoY rate in spite of a global slowdown.

Exports slumped to 5%YoY from 25%YoY in less than twelve months in 2001 (see Figure 1). Moreover, there is a growing possibility that today's global slowdown is more protracted relative to 2001. Our economists are already forecasting 2009 GDP growth at a low 1.4% in the US, 0.7% in Japan, and 0.4% in the Euro area. GDP growth in the developing-world is also expected to weaken next year as the global economy re-couples.

A repeat of 2001, or worse, is thus on the cards. So far, there are only tentative signs that export growth is slowing. Imports from Emerging Asia, or instance, remain firm. However, this tends to be a coincidental indicator. The PMI new export orders sub-component, by contrast, has remained in contraction territory since July. Taiwanese orders from mainland Chinese factories also fell -9%YoY in August, their largest decline since 2001 (see Figure 2).

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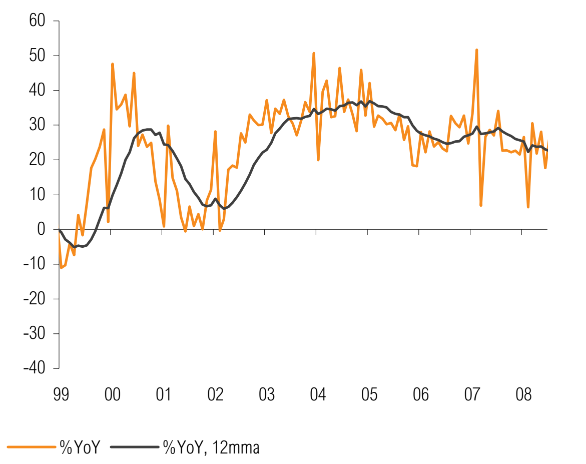
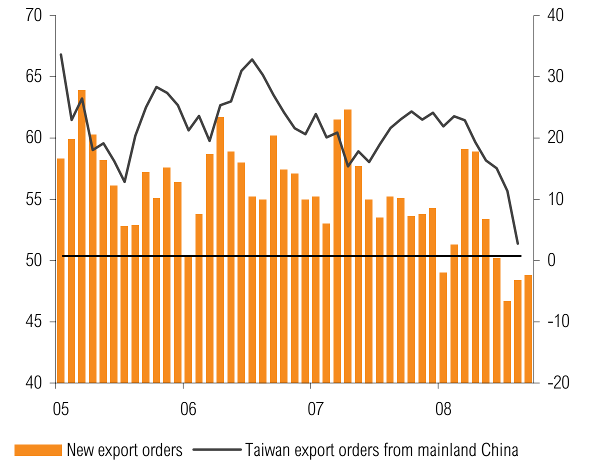
Figure 1: Export growth
%YoY



Source: RBS

Figure 2: Export orders
Index and %YoY (black line marks contraction territory)



Source: RBS

A deteriorating export outlook has negative implications for GDP growth. Still, the export sector's importance is easily exaggerated. Net exports are estimated to have explained just 15% of GDP growth in 2007. Importantly, export manufacturers still rely on heavily on imported component parts. And, imports of component parts, which account for near 45% of total imports, are expected to slow alongside exports in 2009.

Sure, employment growth will slow. However, the export sector employs just 20 million workers versus a total urban labour force of 290 million workers. The sector has also suffered from endemic labour shortage and wage inflation problems since 2004. The unemployed will likely find it easier to find alternative employment relative to 2001 and the impact to private consumption is expected to be modest.

The implications for fixed investment are also mixed. Domestic investment in the export sector may slow. However, again it's easy to exaggerate the importance. Fixed investment in the industrial sector accounts for 23% of total investment, after excluding energy. Moreover, the share includes industries producing for both domestic and external demand, implying the export sector's actual share of fixed investment is smaller.

Foreign investment may even rise. This was the case in 2001 when a global slowdown spurred outsourcing from North Asia, and the rest of the world, into China, as foreign export manufacturers attempted to reduce costs. There are limits to a repeat of this pattern after nearly two-decades of outsourcing. Nonetheless, it's wrong to assume that foreign investment will dry up as the global economy slows.

Stability to remain the guiding FX principle

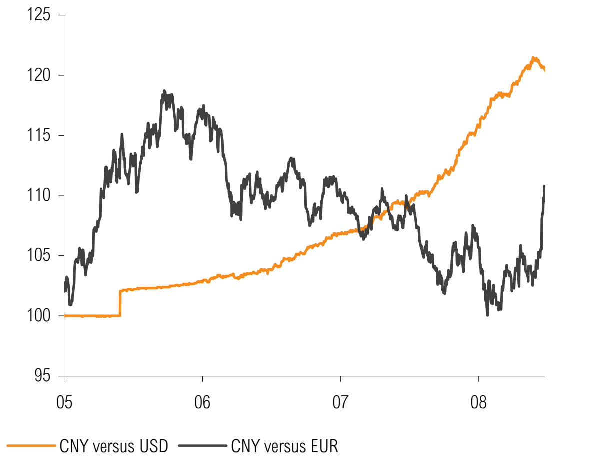
The government is meanwhile likely to respond to economic weakness by spurring domestic demand as opposed to weakening the currency. In 1997 and 2001, the PBOC left the CNY unchanged even as export growth slumped. True, this time it has greater flexibility to intervene. But the PBOC will remain cautious that currency weakness sends the wrong signal to the market at a time of global risk aversion. Stability will remain the guiding principle of FX policy.

The PBOC will also continue to target gains against non-USD currencies, in particular the EUR (see 'The CNY: Expecting smaller gains', 14 Aug). The central bank's preference for currency stability together with its tolerance for CNY gains against either the USD or EUR, but not both, means that a more volatile EUR/USD rate will determine CNY gains in the coming months, as has been the case in the past month.

Accordingly, if EUR/USD continues to drop lower during the remainder of the year, USD/CNY will remain largely unchanged, or even modestly higher by year-end.

The recent experience of the textiles sector also warns against expecting the PBOC to use a weaker currency to support the export sector. The government recently hiked export tax rebates by 2% on selected textile goods in response to complaints from a struggling textiles industry. However, it didn't act until textile export growth was already contracting by near -20%YoY (see Figure 4). Moreover, the increase was below market expectations.

Figure 3: CNY versus USD and EUR
Index



Source: RBS

Figure 4: Textiles export growth
%YoY, 3mma

Source: RBS

Capital-intensive exports are key to the outlook

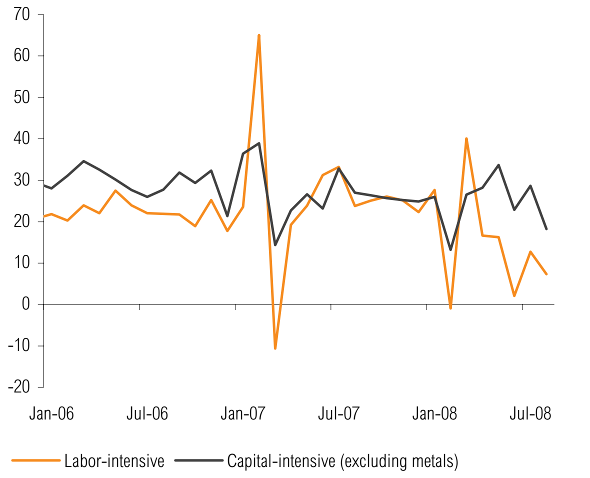
Trying to forecast the export outlook? It's important to focus on capital-intensive rather than labour-intensive exports.

Labour-intensive export growth has already slumped, as illustrated by Figure 5, underperforming capital-intensive export growth since the start of this year. Export growth in the southern province of Guangdong, a major labour-intensive export hub neighbouring Hong Kong, has underperformed export growth in the rest of the country during the same period. Factory closures in the province have captured significant media attention.

Yet this development is already well recognized. Indeed, we wrote earlier this year that Guangdong's exporters were struggling to cope with rising wage and raw material costs, in addition to a stronger currency (see 'Rising costs: Exporters are hurting', 10 April). Moreover, the share of labour-intensive exports has fallen to 25% of total exports (see Figure 6), so while interesting from a structural perspective, the performance of labour-intensive exports is less important to the overall trend.

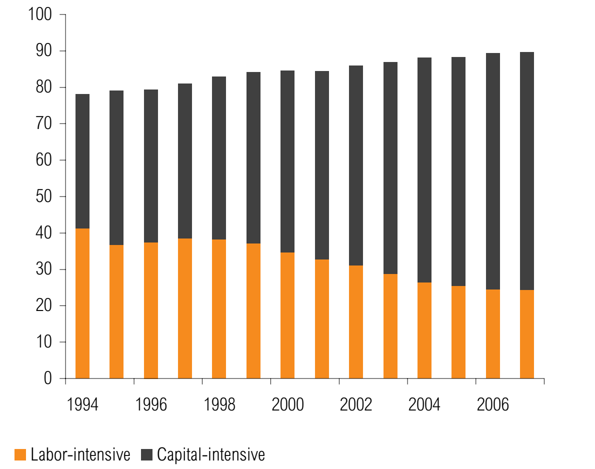
More important are capital-intensive exports. The category includes everything from low-end laser printers to high-end notebook PCs. In 2007, capital intensive exports explained 49% of total export growth whereas labour-intensive export growth accounted for a far smaller 24%. In the first half of this year, capital-intensive exports rose at a robust 25%YoY. However, the pace has since slowed to 18%YoY in August raising fears that they are finally slowing in response to weaker global demand.

Figure 5: Labour- versus capital-intensive exports
%YoY



Source: RBS

Figure 6: Share of exports
Percent share of total exports



Source: RBS

The next few months will prove critical. Shipments for the Christmas-holiday sales season started in July for labour-intensive goods. But capital-intensive goods tend to be shipped later in the year as they are typically shipped by air-freight. The fact new export orders from Taiwan are contracting on a YoY basis, coupled with recently weaker demand in the developed economies, suggests capital-intensive exports will shortly slow.

It's not all bad news. Export growth unlikely to fall sub-0%Y/Y

There are caveats to the forecast, as the drivers of export growth have changed since 2001. As Figure 8 illustrates, the Euro area, Japan, and the United States accounted for 45% of export growth prior to 2001 versus 30% today. The non-Asian developing world has taken up the slack. Its share of export growth has risen from 10% to 25%. The upshot is that non-Asian developing world demand is nearly as important as developing world demand.

Moreover, China also has a tendency to capture market share during a slowdown. Its share of United States imports accelerated rapidly in 2001 as consumers switched to low-cost Chinese substitutes. Its ability to repeat the same feat in 2009 is weakened by the fact its US market share has risen from 8% to a sizeable 16% in the period. Indeed, for some products, such as furniture, its market share has risen from 32% to 56%.

Not so in Europe. As Figure 9 illustrates, China's share of German imports is still less than half the comparable United States figure. It's not always possible to compare between markets. However, the experience of the United Kingdom offers a useful European benchmark, as China's share of United Kingdom imports have surged in the past two years almost simultaneous to a collapse in consumer sentiment (see Figure 10).

Figure 7: China's exports by country
%YoY, 12mma

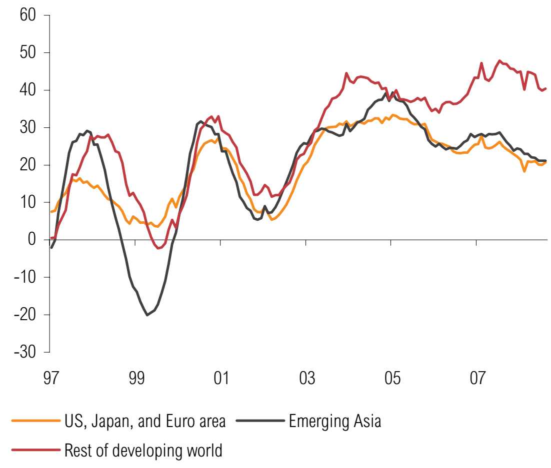
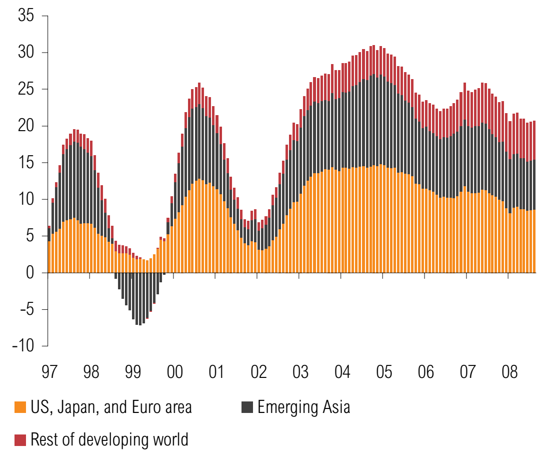
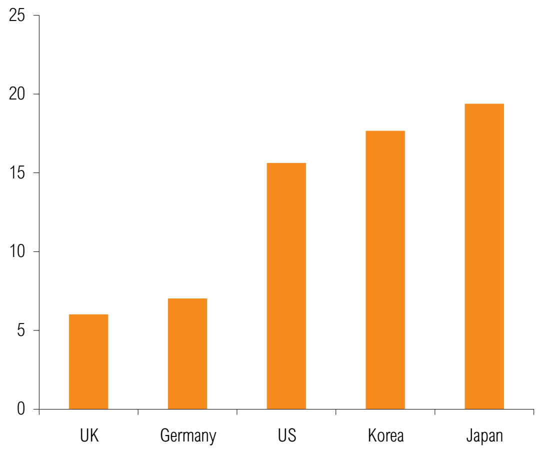


Figure 8: China's exports by country
Percentage point contribution to YoY growth



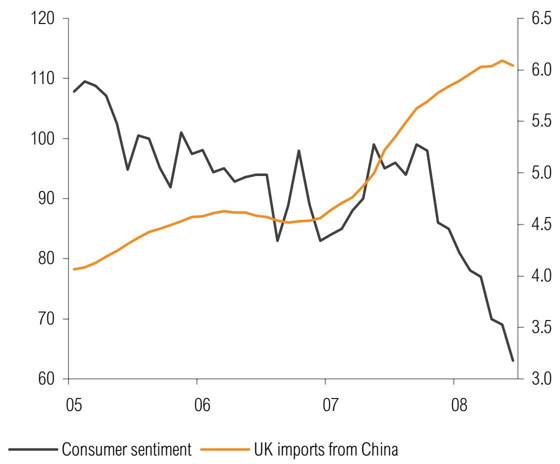
The risk to this view is significant EUR weakness versus the USD and, by implication, the CNY. However, the more likely outcome is that China's share of the Euro area imports rises in 2009. The Euro area's trade deficit versus China is accordingly expected to widen as the region's imports of consumer goods from China remains firm, even as its mainly chemicals and machinery exports to China slows.

Figure 9: Imports from China
Percent share of total imports, latest twelve months



Source: RBS

Figure 10: UK's imports from China versus sentiment
Percent share of total imports and index



Source: RBS

The implication is that China's export growth will slow, but it isn't expected to fall sub-0%YoY.

Figure 11 below illustrates a number of potential scenarios ranging from a mild to more severe global slowdown. We assume that demand in the developed world will weaken more relative to 2001. We also assume that demand in the non-Asian developing world demand will also weaken, as the global economy re-couples, but not collapse. Our preference is for scenario 2. However, we can't rule out scenario 3 in the event of either a more sustained collapse in developing-world demand or significant CNY strength against the EUR.

Figure 11: Export sensitivity

Export growth in 2009, %YoY

		Export growth in 2009		
	Current	Scenario 1	Scenario 2	Scenario 3
Total exports	22	10	5	0
US	13	5	0	-5
Japan	19	5	0	-5
Euro area	24	10	5	0
Asian developing world	18	10	5	0
Non-Asia developing world	37	20	10	5

Source: RBS