China Vs. Indonesia: A tale of two economies

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Outlook & Commentary

Covid-19, rising US rates and surging commodity prices have taken different tolls on Asian economies. China and Indonesia are likely to be at the two ends of the current macro-economic spectrum. In this paper, Christiaan Tuntono, Senior Economist for Asia Pacific at Allianz Global Investors shares his outlook on the two economies.

Three key macro drivers impacting Asia

We identify **policy responses to Covid-19, rising US rates and surging commodity prices as the three main macro drivers impacting Asia**. These drivers have taken varying tolls on Asian economies. For responding to Covid-19, whether an economy adopting a Live-with-Covid Policy or Zero-Covid Policy makes a vast difference in its reopening schedule. For rising US rates, almost all Asian economies are negatively affected. For surging commodity prices, most Asian economies are disadvantaged because of their net-energy/commodity importer status, but Indonesia and Malaysia stand out as the beneficiaries given their net-exporter status.

China and Indonesia are likely to be at the two ends of the current macro-economic spectrum. The two economies differ on how they manage Covid-19, the extent of impact they have under rising US rates, and how their external accounts behave under surging commodity prices. Such differences made them switch place as the likely underperformer (China) and outperformer (Indonesia) in the region.

China: Rising growth risk, weakening balance of payments

China has fallen from a first-in-first-out haven to a first-in-last-out quagmire against Covid-19 due to the government's insistence on Dynamic Zero Covid Policy ("Zero-Covid"). Different from the situation in 2020 and 2021, the surge of the much virulent Omicron variant in China has posed severe challenges to the country's Zero-Covid approach.

The month-long lockdown in Shanghai has tarnished investors' confidence on China's ability to achieve this year's growth target and the sustainability of Zero-Covid. According to the government's Covid-19 risk-tiering, geographic regions representing around 8% and 10% of China's national GDP were under full and partial lockdown, respectively, through April.

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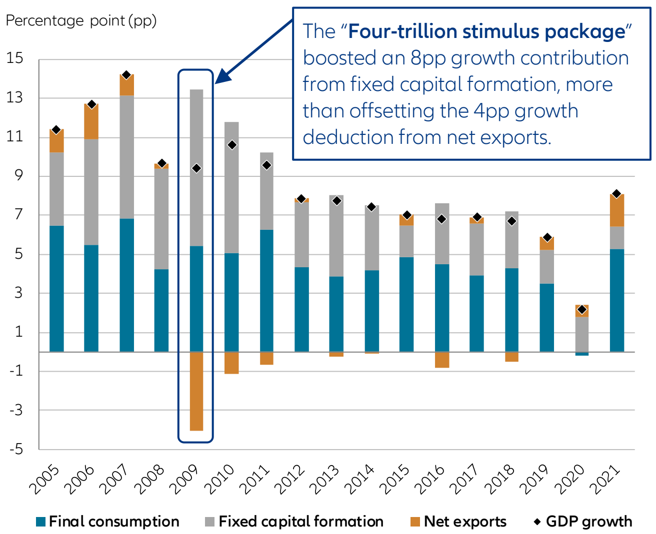
Further, assuming that the negative impact on economic activities under full and partial lockdown were at 50% and 25%, respectively, China could have lost around 0.5 percentage point of annual GDP growth from the latest Omicron outbreak in April alone. This raises doubt on whether the government can still achieve the official "around 5.5%" growth target, especially if more cities got lockdown under Zero-Covid in future months.

The government responded with getting even more resolute on Zero-Covid and vowing to bolster growth through stronger infrastructure investments and greater policy supports. Much to the market's surprise, the Politburo of the Chinese Communist Party (CCP) has decided to double-down on both Zero-Covid and achieving this year's social and economic targets. This could stem from the fact that the CCP will host the critical 20th Party Congress in October to confer a third term to President Xi Jinping, hence persisting on Zero-Covid and pump-priming the economy could be seen as safest path over the next six months.

Outlook on China's macro condition turns binary, contingent upon the success of the government's ambitious plan. Although private-sector activities were severely hampered and may deteriorate further, history shows that public-sector infrastructure investments can be a powerful offset. Back in 2009, the government launched the "Four-trillion Stimulus Package" to bolster growth in the aftermath of the Global Financial Crisis at the expense of surging leverage and falling investment efficiency (see Figure 1). We think the government is capable of bolstering infrastructure investments again this time around if it is willing to bear the negative consequences in years to come. China can achieve the "around 5.5%" growth target synthetically, though there remain uncertainties on the government's determination and effectiveness. (see Chinese roulette: red or black?)

Figure 1: Contribution to headline GDP growth



Source: CEIC, AllianzGI Economics & Strategy, as of May 2022.

Chinese roulette: red or black?

While the 2022 outlook for China's growth seems gloomy with a disappointing start in the first half of the year, history shows that the Chinese economy tends to surprise during the second half of the year. The secret lies in **a large public sector - estimated at around 40% of China's GDP**, which can provide a powerful offset to a struggling private sector.

Back in 2009, the Chinese government launched the "Four-trillion Stimulus Package" to bolster infrastructure investments in the aftermath of the 2008 Global Financial Crisis. The rapid expansion in public-sector investments, coupled with a jump in private real estate investments, contributed a total of 8 percentage points to headline GDP growth in 2009 and more than offset a 4-percentage point drop in net exports due to the collapse of global demand.

However, the "synthetic" creation of domestic demand came at a cost. In subsequent years, China suffered from a sharp surge in private- and public-sector leverage and persistent decline in investment efficiency, and these problems are still not resolved.

That said, we think the Chinese government is capable of turning on the turbo again this year if it is determined to boost growth and willing to live with the bitter aftertaste. China can achieve the "around 5.5%" growth target in 2022 if it really insists, but to regain the market's confidence it will need more evidence of Covid-19 being under reasonable control, the state machine running at full steam and a "whatever-it-takes" determination to save growth.

The trajectory of China's growth matters to emerging markets and the world economy because the country is the greatest contributor to global growth. As the greatest commodity purchaser, **China's growth also matters to the outlook for the global commodity markets** and the prices of key energy/commodity products such as oil, coal, LNG, iron ore, steel, aluminum, etc.

Getting China's growth outlook "right" over the second half of this year is challenging and the outcome is likely to be binary. Will it be red or black? The marble is rolling and will soon find its place.

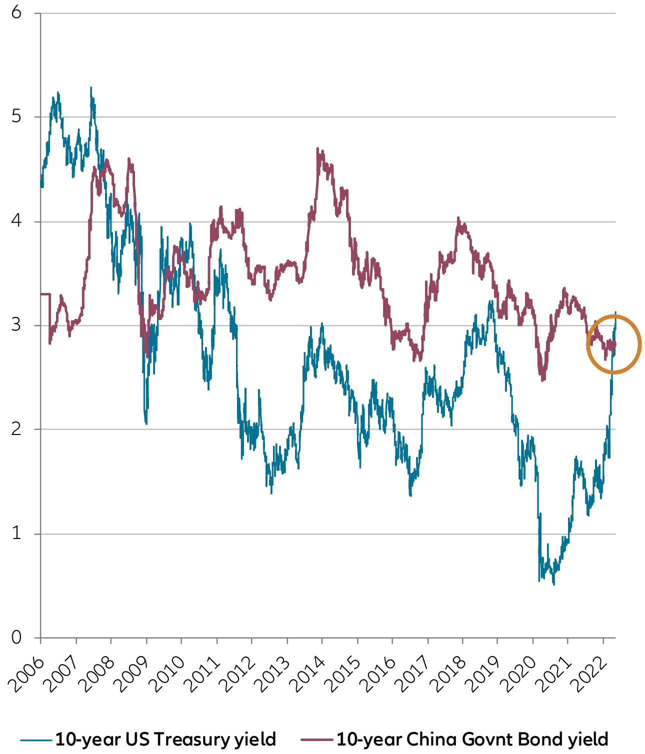
Meanwhile, the nominal yield differentials between US Treasury and China Government Bonds have closed (see Figure 2), weakening bond portfolio inflows. Both the nominal 10-year US Treasury (UST) yield and China Government Bond (CGB) yield have reached 2.8% - 3% lately.

Although on a real basis CGB still has a positive yield gap vis-à-vis UST, the latest data shows that bond portfolio flows have started weakening. Equity portfolio flows have also weakened amidst a turbulent market condition. Both trends are negative for the capital and financial accounts under China's balance of payments.

The surge in global commodity prices, coupled with slowing global export demand, may also pressure China's current account balance. As a net energy and commodity importer, China receives a negative terms-of-trade impact from surging global commodity prices. This effect is likely to keep nominal import growth resilient, even though in volume terms import demand remains pressured by Zero-Covid. Meanwhile, China's export demand is likely to weaken as global growth slows and demand shifting back from goods towards services. These two effects are likely to weaken China's trade/current account balance further.

The weakening of China's balance of payments is likely to exert greater pressure on the renminbi. We think the renminbi is likely to weaken further in 2022 as China's balance of payments condition deteriorates. The sharp depreciation of the yen added further pressure on the North Asian currencies.

Figure 2: 10-year US Treasury Vs. 10-year China Government Bond yields



Source: Bloomberg, AllianzGI Economics & Strategy, as of May 2022.

Indonesia: Benefitting from positive terms-of-trade

In our view, Indonesia is in a better position when compared with China. The adoption of a Live-with-Covid Policy, wider nominal and real rate differentials with the US and net commodity-exporter status have put Indonesia in a more favorable position vis-à-vis China.

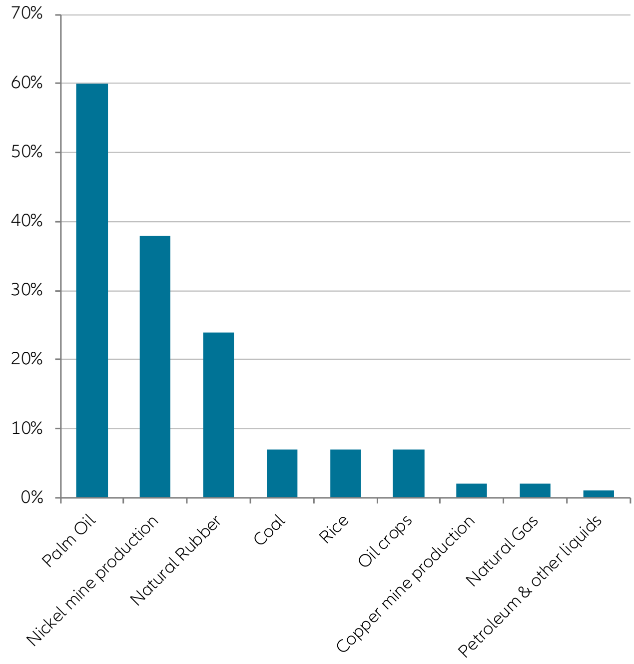
While Covid-19 vaccination coverage is still far from widespread, the latest wave of Omicron-driven infections peaked relatively quickly and has so far resulted in far fewer deaths compared with previous outbreaks. Only about 60% of Indonesian population was vaccinated and a smaller proportion received booster shots. But that said, even when Omicron infections surged during February and March, the government has refrained from imposing strict nationwide lockdowns in view of the lower severe illness rate in comparison to the Delta variant wave in 2021. This is the reason why the economy can continue recovering through the first quarter of 2022 into the second quarter.

The economy is reopening, benefiting domestic demand and foreign tourism. The recently announced GDP growth report for the first quarter of 2022 shows a resilient 5% year-on-year headline growth, driven by continued recovery in private consumption (+4.4% yoy) and gross fixed capital formation (+4.1% yoy). Net exports also contributed positively to headline growth, thanks to strong commodity prices. As the economy reopens, stronger domestic demand and revived foreign tourism are expected to accelerate Indonesia's full-year GDP growth to 5.4% in 2022 from 3.7% last year.

As a major commodity exporter, Indonesia benefits from the surge in prices of its main commodity exports, helping to offset higher crude oil import costs. Indonesia is a resource rich country and its main commodity export products include coal, palm oil, nickel, natural gas and others (see Figure 3). Total commodity trade balance is sizable at 4.5% of GDP (Figure 4), consisting of a 5.6% of GDP non-oil and gas trade surplus and a 1.2% of GDP oil and gas trade deficit. Elevated global commodity prices are hence likely to keep Indonesia's current account balance in a small surplus again this year.

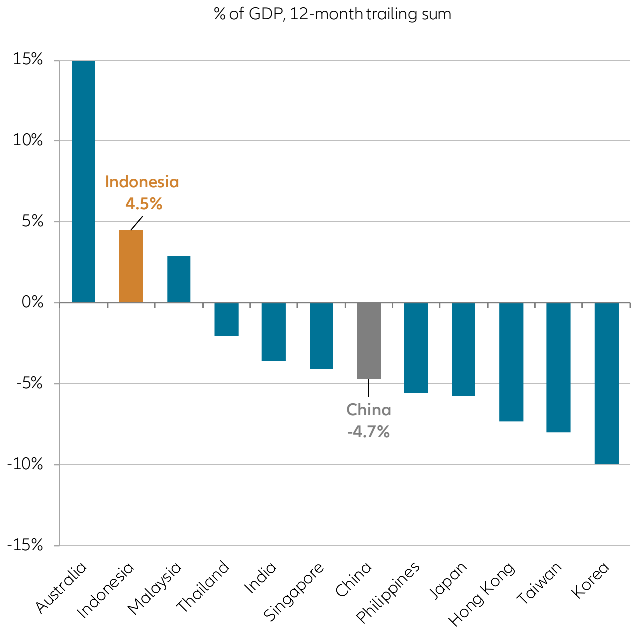
Still hefty nominal and real rate differentials with the US, coupled with improved macro fundamentals vis-à-vis 2013's "taper tantrum," allow Bank Indonesia to normalise monetary condition at a more gradual pace than the Fed. Same as other Asian economies, we expect rising US rates and strong US dollar to pressure Indonesia's external accounts and the rupiah. But that said, Indonesia's current account is buffered by high commodity prices, while its capital and financial account remain supported by hefty nominal and real yield differentials with the US dollar.

Figure 3: Share of Indonesia in global production



Source: CEIC, Haver Analytics, AllianzGI Economics & Strategy, as of May 2022

Figure 4: Asia's commodity trade balances



Source: CEIC, Haver Analytics, AllianzGI Economics & Strategy, as of May 2022.

Rising food and energy inflation are concerning, but the government is tackling them through fiscal and administrative means. We expect Bank Indonesia to start its rate hike cycle soon, but not necessarily in lockstep with the Fed.

To view more market insights from Christiaan Tuntono, visit ap.allianzgi.com

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