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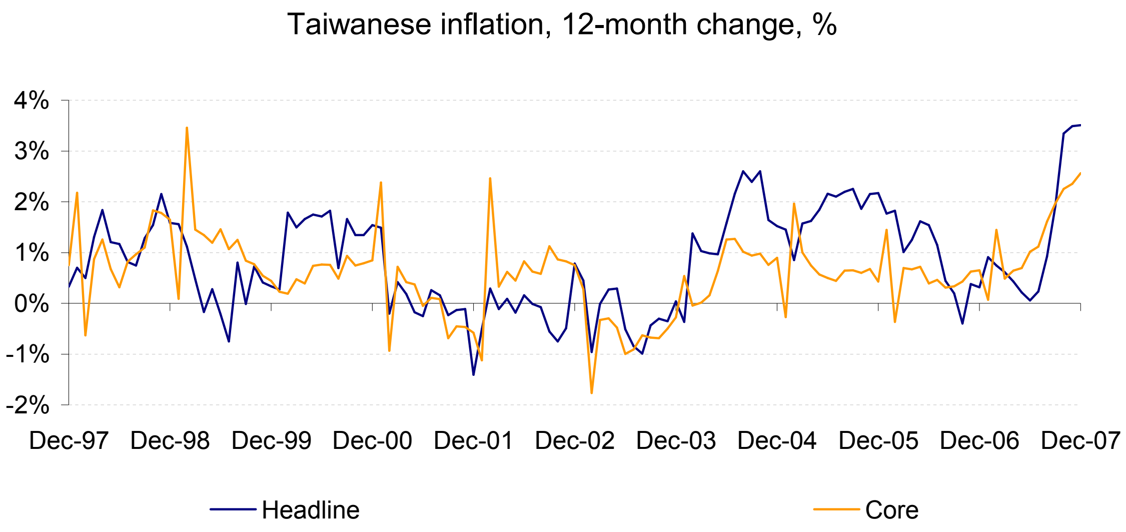
Trade rerouting postpones Taiwanese (et al) slowdown

WE SUGGEST: CBC still more likely than not to raise interest rates in March

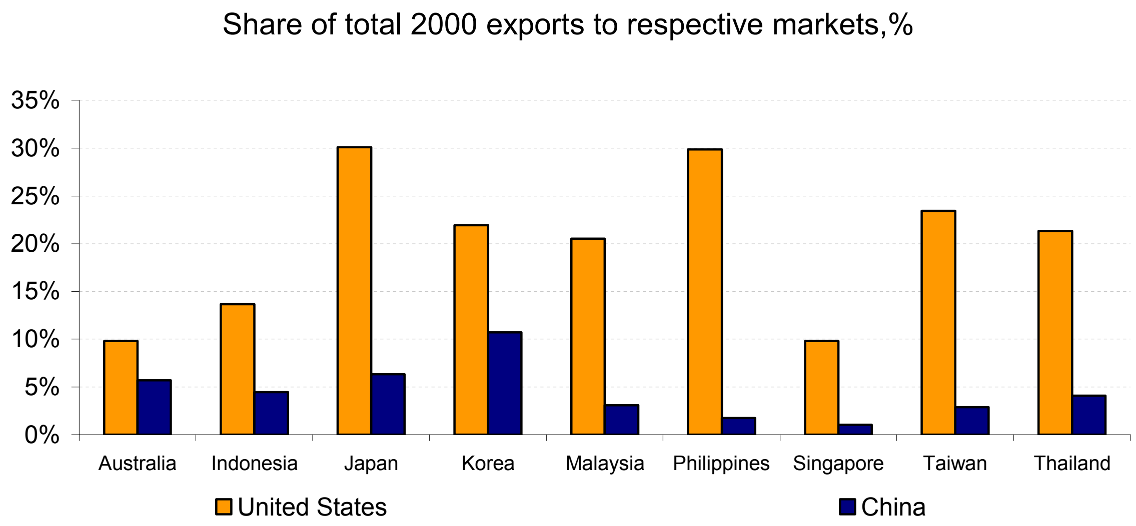
SUMMARY: We do not believe that the Asian economies have decoupled from the US. But shifting trade routes in the Far East means that the impact of US developments may be delayed through the interposition of China. This, coupled with rising inflation rates, means that some central banks (RBA, CBC) are still more on course to tighten than to ease monetary policy.

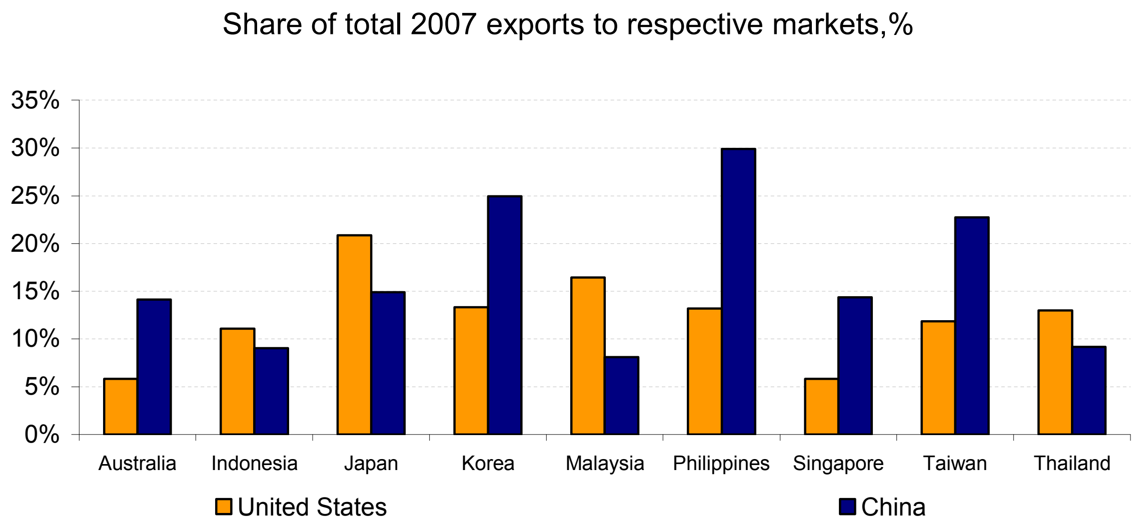
According to the Taiwanese newspaper *Commercial Times* the Central Bank of China (CBC) is still on course to raise interest rates this quarter. In the wake of the Fed 75bp cut in the Fed Funds rate earlier this week, this seems puzzling – not least since Taiwan is generally described as the Far Eastern economy likely to suffer the most from a US slowdown. If pressure on non-US central banks to follow the Fed's lead is increasing, should not Taiwan be a prime candidate for cutting interest rates? But this argument ignores two factors. First, Taiwanese inflation is not only high, but accelerating. True, the headline rate slowed slightly to 3.4% in December; but both the headline and the core rate – CPI excluding fish, vegetables, fruit and energy – are at more than 10-year highs. On a six-month annualised basis, a better guide to recent trends, the headline rate was 5.8% in December, while the core rate was 3.8%; in both cases the fastest rate since 1995.



Moreover, while we are sceptical of the decoupling story, there is a grain of truth in it. Our scepticism relates to the view that the Far Eastern economies can avoid (at least some, if not all) the consequences of a US slowdown. That is highly unlikely; countries that pursue export-led growth can by definition not avoid being harmed by a slowdown in one of their most important export markets. However, where there is some truth in the decoupling story, is that as the importance of the US has diminished, the time lag between US developments and their impact on the Far East has probably lengthened.

This, needless to say, is due to the interposition of China. Over the past twenty years, trade patterns in the Far East, as elsewhere, have shifted. In 1990, none of the larger Far Eastern economies (Australia included) exported very much to China; among the main tigers, Indonesia was the one with the biggest exposure to China, 3.2% of total exports. By contrast, exports to the United States ranged between 11% of total exports (Singapore, Australia) and 37% (the Philippines). By 2000, this had begun to change; but the United States was still a more important export market than China for the Tigers. But by last year, the shift had progressed so far that China was a more important export market for five of the nine largest Far eastern economies – and even for those where the United States remained the larger export market (eg Japan), the disparity between the two had sharply diminished.





Of course, a substantial share of this is a shift on assembly from, eg, Taiwan to China. The same goods may still be ultimately exported to the United States – or elsewhere. The region's emphasis on export-led growth is not diminished. But it does mean that the impact of a US slowdown will take somewhat longer to spread to the smaller economies in the region, since it comes by way of China, rather than directly.

Moreover, if – a big if – the Chinese authorities respond to a US slowdown by stimulating domestic demand, then some of the impact will not only be delayed but diluted as well. (For the moment, with the Chinese authorities concentrating on dampening an overheated economy, such a shift does not seem likely. This may change in the course of 2008 – but probably not until later in the year).

In the meantime, China is exporting overheating to its neighbours. Over the past twelve months, headline inflation has not only risen in Taiwan (from 0.3% to 3.5%) but also in Korea (from 2.1% to 3.7%), Singapore (from 0.8% to 4.5%), Hong Kong (from 2.2% to 3.8%). The Fed may – will – continue to cut interest rates. But, for the immediate future, there are a cluster of central banks that are still more intent on tightening their monetary policies.

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