Economist Insights

Trading down

Asian exports have previously been a good early warning signal of a global downturn. Asian exports have taken a dive once more, so does this mean that the recent optimism about prospects for developed market growth is misplaced?

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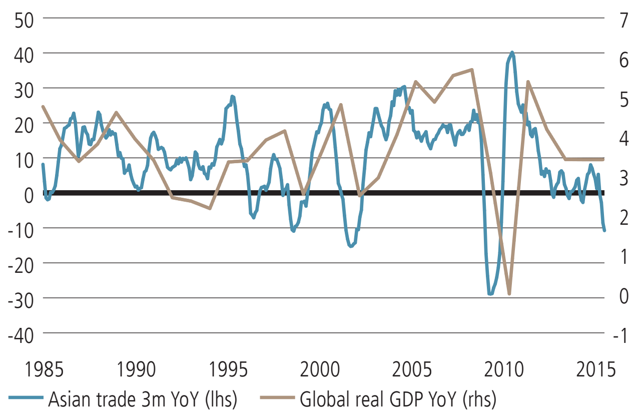
A good doctor will always look for early warning signs of illness in her patients. A rapid heart rate perhaps, or maybe a high fever, or spells of dizziness. Spot the warning signs early, and you may save someone's life. But set off a false alarm and you could mistakenly incur an expensive medical cost for no purpose. So it is with market economists (though of somewhat less than mortal importance). Spot a downturn in the economy early and you could save your investors a fortune. But call a downturn that does not happen and you could cost them a fortune.

So economists spend a lot of time looking for early warning signals. But the economy is not quite as static as the human body: physiology has not changed much in the last fifty years, although doctors' understanding of it has. In contrast, the world economy has changed a lot in the last fifty years. Cynics might argue that, also in contrast to doctors, economists' understanding of the economy has not improved much in the last fifty years. A moving target is always harder to hit. Nonetheless, economists do often find good early warning signals that the economy is running into trouble. But with an ever-changing world economy, it is perhaps no surprise that economists are cautious about reading too much into the early warning signals.

One good early warning signal has been Asian exports. Almost every time that Asian exports have experienced a downturn, the global economy has experienced a downturn as well (chart 1). The link was not so clear cut in the 1980s and early 1990s, but back then the Asian economies were not as closely integrated into the global economy. Yet still the pattern tends to follow. The big exception is in 1997-98, when the Asian crisis brought down Asian exports yet the rest of the world maintained decent growth.

Chart 1: Alarm bells

Value of Asian exports in USD, 3m average over one year earlier, and Global real GDP growth, %



Source: Thomson Reuters DataStream, IMF, UBS Global Asset Management.
Note: Asian exports are in USD terms from China, Korea, Taiwan and Singapore.

Now Asian exports have taken a dive once more, at the same moment that most people are becoming more optimistic about the prospects for growth in developed markets (DM). Is that optimism misplaced?

If Asian economies are finding it hard to export, it is likely to reflect weak demand in other countries. Hence the warning signal: if Asian exports are primarily to DM, then a drop in those exports could well indicate a slowdown in DM. This is the kind of warning sign that economists are always on the lookout for.

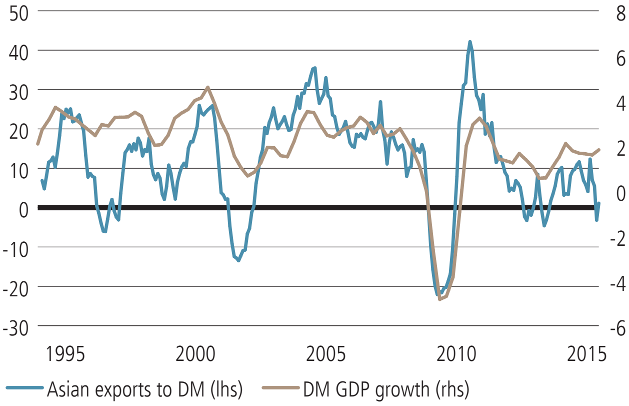
Both China and Hong Kong peg their exchange rate against the USD, so the appreciation of that currency has brought about an appreciation of their currencies as well. The real effective exchange rate (which takes into account trade patterns and price levels) for both countries has risen dramatically over the last year, and has been broadly flat for South Korea and Singapore. So the exchange rate may explain some of the weakness in China and Hong Kong, but it does not explain the weakness in the other two markets.

Vertical integration of trade may help explain why the weakness is so widespread. Many production processes are spread across the region, for example with components made in Korea, assembly in China and packaging in Hong Kong. So a drop in demand for the final product hits the exports of all three economies. Yet this vertical integration also makes the starting level of measured Asian exports look higher, so proportionately the impact of this integration should make little difference to the growth rate.

Maybe the problems are indeed confined to Asia, and it is purely a regional weakness. Maybe it is just that intra-regional trade is more important and Asian economies are simply exporting less to each other. Yet exports from Latin America are showing a similar weakness. Perhaps the problems are confined to emerging markets (EM)? If so, then exports from Asia to DM should remain stronger. The export data with a country destination breakdown does not go as far back, but it does correlate fairly well with recent economic cycles (chart 2). However, the weakness in Asian exports to DM is not as severe, and growth even turned positive in June.

Chart 2: For whom the alarm bell tolls

Value of Asian exports in USD to developed markets (DM), 3m average over one year earlier, and DM real GDP growth, %



Source: Thomson Reuters DataStream, IMF, UBS Global Asset Management.
Note: Asian exports to DM are from China, Korea and Taiwan to USA, Canada, UK, Germany, Italy, France, Netherlands, Australia and New Zealand.

Early warning signals work until they don't. A moment can always come in the ever-changing global economy when structural shifts break down relationships. So when in doubt, look for corroboration. Other early warning signals are not as pessimistic; for example the purchasing manager indices. And the US yield curve is not inverted, which has been a necessary (if not sufficient) precondition for a recession there. But then again, there is always a temptation to find excuses to ignore bad data. Perhaps it is the other early warning signals that are broken.