OXFORD ECONOMICS

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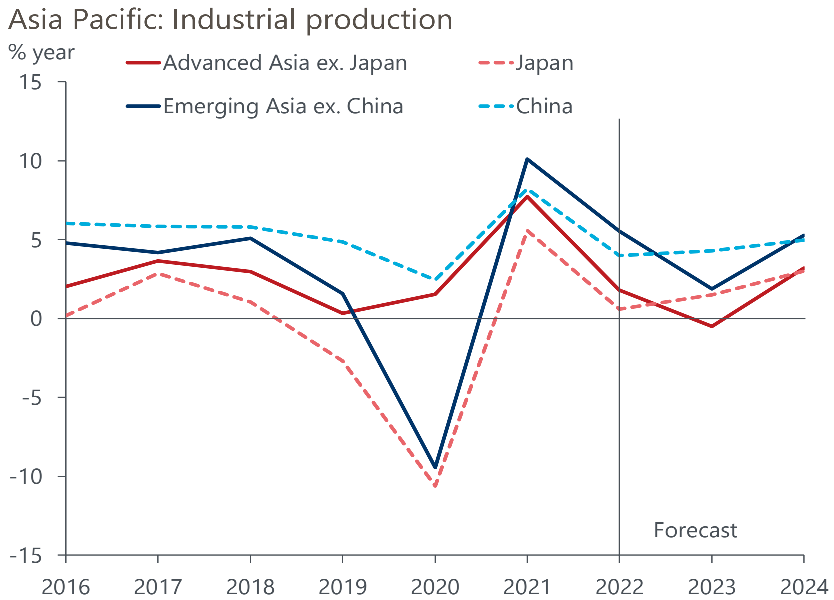
Research Briefing | Asia Pacific

Easing supply hurdles won't offset falling industrial demand

- **We expect industrial growth in Asia ex-China to slow to 1.3% in 2023 from 3.8% in 2022, as weak demand weighs on output, despite easing supply chain pressures. China's industry will benefit from accommodative domestic policies. That said, we see mainland's industrial growth rising only 0.3ppts to 4.3% next year amid weakening external demand.**
- **Falling input costs and improving supply prospects are good news, especially for those industries hit hard by shortages, such as the automotive sector. But we continue to think that demand prospects hold the key to Asia's industrial outlook. And the trends are already discouraging, especially for the more export-oriented manufacturers in North Asia.**
- **We think China's GDP growth will not be fast enough in 2023 to offset the fall in demand for Asia's goods from the recession-bound advanced economies. The anticipated rotation away from goods to services demand and signs of oversupply in the semiconductor industry are further drags on the external demand outlook.**
- **Meanwhile, the post-pandemic recovery in domestic demand is likely to fade given rising interest rates and the anticipated slowdown in income growth.**
- **There are both upside and downside risks to our baseline: much is riding on how China's zero-Covid policy plays out in 2023, while a more aggressive US rate-hiking or stickier input prices bodes ill for Asian manufacturers.**

We earlier argued that Asia's manufacturing activity has been impacted more by demand than by supply-side pressures, due to strict Covid-related policies. Supply constraints in Asia have been less acute than in the US and Europe, and we had forecast resilient industrial growth in 2022 and 2023 as regional demand recovers. But the global growth outlook has deteriorated since then. Following our recent downgrade to 2023 GDP growth forecasts for most Asian economies, we now expect weaker industrial growth in Asia. That said, there will be divergences across the region (**Chart 1**).

Chart 1: Faltering demand will weigh on industrial output next year



Source: Oxford Economics

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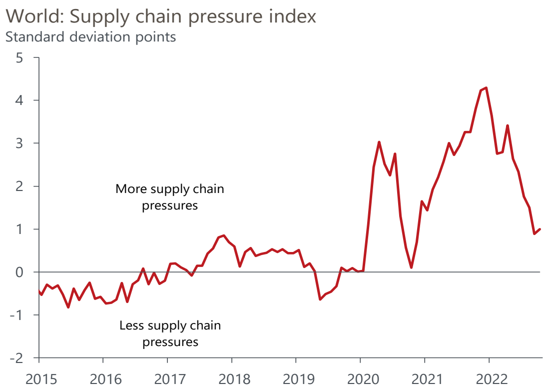
Production shows mixed trends in Asia

Notwithstanding the continuing uncertainties from geopolitical tensions, supply chain pressures are improving (**Chart 2**). Input costs are peaking as commodity prices ease. But moderating supply constraints haven't translated into output growth across Asia as demand conditions have diverged.

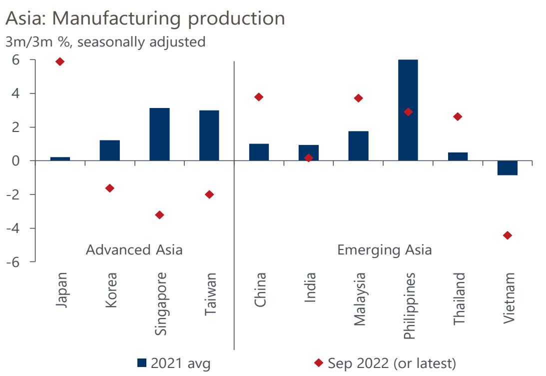
Chart 2: Supply chain pressures have eased



Source: Oxford Economics/New York Fed/Haver Analytics

Latest data show mixed trends in industrial activity in Asia (**Chart 3**). Unsurprisingly, China is seeing a rebound after the major Covid lockdowns earlier in the year. But output is also rising at a solid pace in Japan and parts of Southeast Asia. The former is benefitting from backlogs in the auto industry, while the latter is gaining from reviving tourism and pent-up demand from delayed re-openings. Taiwan and South Korea, on the other hand, are dealing with sequential contractions in factory output, as is Singapore, due to a slowdown in the global electronics cycle.

Chart 3: Mixed production trends in Asia



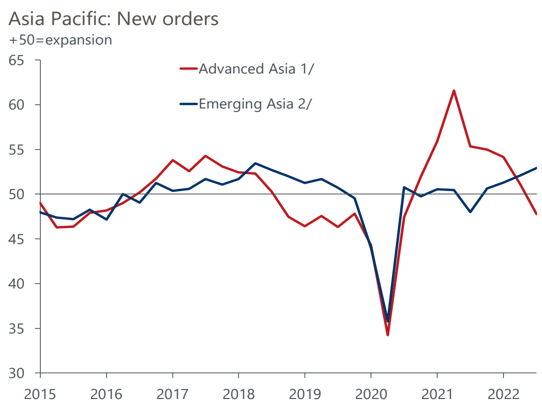
Source: Oxford Economics/Haver Analytics
Note: Philippines 2021 growth was 17.6% on average.

In the short term, we still see some pockets of optimism. We expect Japan's auto production will continue to recover into early 2023, which should bolster manufacturing output, as auto industry accounts for 16% of Japan's industrial production. Our industry team expects Japan's auto production will expand 8.8% in 2023. Moreover, India and Southeast Asia could see positive effects from firms diversifying away from China given the rising risks of technological decoupling between China and the West. However, on the whole, we think that reasons for optimism are fading fast.

Demand side drivers are buckling

Signs of weaker global demand are already visible in the manufacturing PMI surveys. New orders have come down in the advanced Asian economies. They are still showing an uptrend in emerging Asia (**Chart 4**), but this is primarily because of rising domestic orders. We think it is only a matter of time before temporary boosts from re-opening and "post-Covid" normalisation give way to weakening domestic demand, amid tightening financial conditions and slowing global growth.

Chart 4: Emerging Asia benefits from improving domestic demand



Source: Oxford Economics

1/ Australia, South Korea, New Zealand, Singapore, and Taiwan.
2/ China, Indonesia, and Thailand.

After our latest growth downgrades, we now forecast a mild global recession in 2023. This is particularly bad news for Asia's largely export-oriented manufacturing sector, and we expect the industrial slowdown to become broad-based and gather pace into Q4 2022 and H1 2023. Domestic stimulus measures will likely keep China's industrial production from slowing further. But

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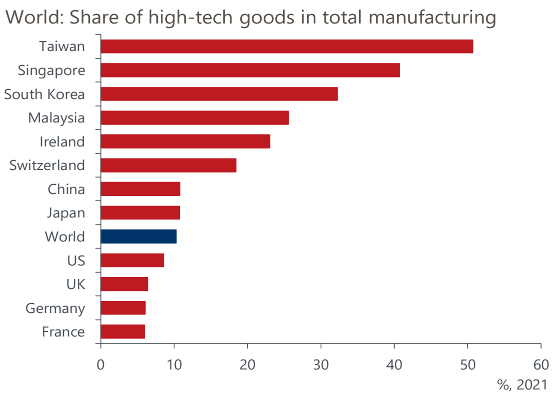
with exports accounting for more than 50% of the mainland's manufacturing output, the slowdown in external demand will limit the output next year.

Further accentuating the downside pressures on Asia's production will be the ongoing rotation away from goods to services and growing signs of oversupply in the semiconductor industry. From mid-2020 until recently, chip demand boosted economies focused on high-tech goods. In Asia, Taiwan was the key beneficiary, followed by Singapore and South Korea (**Chart 5**). But those economies are being buffeted by the slowdown in chip demand. Our industry team forecasts global electronics production will only grow 2.6% in 2023, down from 6.3% this year.

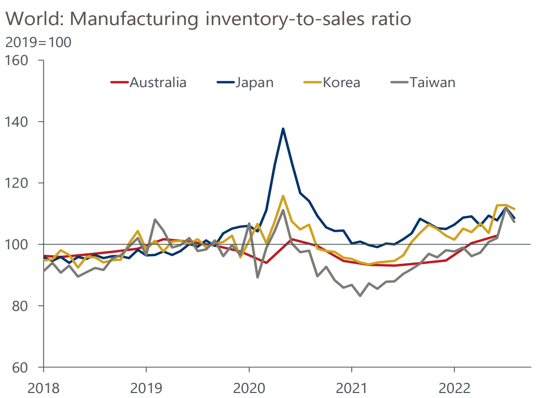
Chart 5: A dependence on high-tech goods in Taiwan, Singapore, and South Korea



Source: Oxford Economics

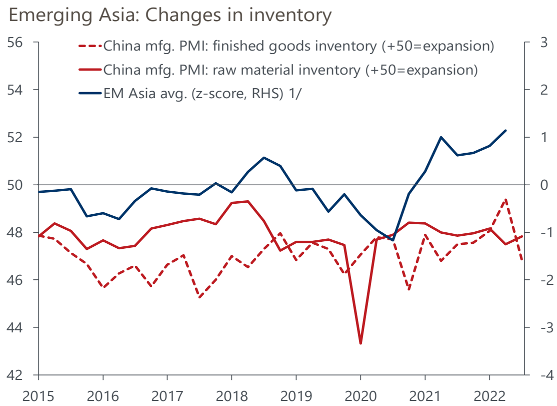
Meanwhile, easing supply chain pressures have led to a build-up of inventories, which will drag on production in an environment of falling demand (**Chart 6** and **Chart 7**).

Chart 6: Inventories are building up again…



Source: Oxford Economics/CEIC Data/Haver Analytics

Chart 7: …and will drag on production as demand weakens



Source: Oxford Economics/CEIC Data/Haver Analytics
1/ Value greater than zero indicates that changes in inventory are above historic levels.

Sharply lower industrial production growth in 2023

Overall, we forecast Asia's industrial production growth to slow to 2.7% in 2023 from 3.9% in 2022, before recovering to 4.7% in 2024 (**Chart 1**). We expect the downturn to be especially pronounced for advanced Asia, though Japan should outperform. In our baseline, we foresee industrial production in advanced Asia ex-Japan contracting 0.5% in 2023, after growing 1.8% in 2022. Excluding China, we see industrial growth in emerging Asia slowing to 1.9% next year from 5.5% this year.

Admittedly, China remains a wildcard, potentially with both upside and downside risks. China does not suffer from an input cost problem. And we continue to look for a recovery next year in Chinese growth. But we have toned down our expectations considerably, and much depends on how the zero-Covid approach progresses and its impact on demand and industrial activity.

A faster pace of interest rate hikes, both regionally and globally, is a key downside risk to our baseline forecast, as it would result in weaker demand than we currently forecast and raise the cost of capital for manufacturers. Uncertainties also abound on logistics and other supply side issues. While producer prices may be peaking in many places, ongoing geopolitical tensions could result in energy and other raw material prices staying higher for longer.

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