more give, less take

Emerging Asia

NAB Group Economics

September 2015

Summary & Overview

- Concerns about the extent of slowing in China, the anticipated rise in the US Fed Funds rate, and sharp declines in commodity prices have generated unease about the impact on emerging markets (EMs).
- There have been falls in EM currency and equity markets, as well as portfolio outflows, particularly for equities over the past 3 months.
- This analysis adopts an indicator-based approach to focus on 5 key Asian Sovereigns: Indonesia, Malaysia, Thailand, South Korea and Taiwan.
- Emerging Asian countries are better off than when the Asian Financial Crisis struck in 1997. Unlike 1997, most have flexible exchange rates, and have substantially built up their foreign exchange reserves. However, there remain differences among them.
- Among the major Asian Emerging economies, South Korea and Taiwan, appear stronger than the rest. Both of them run current account surpluses, have high levels of foreign exchange reserves and maintain positive net foreign assets.
- Conversely, both of the above countries are strongly impacted by a slowdown in China through the trade channel.
- Indonesia runs a current account deficit and is net external debtor. However, its foreign exchange reserves are reasonable, and it's somewhat less exposed to a potential downturn in China.
- Malaysia and Thailand both run current account surpluses. Further, Malaysia is a net foreign creditor, unlike Thailand. However, Malaysia's foreign reserves are less than adequate; in contrast, Thailand's reserve coverage is adequate.
- Malaysia and Indonesia both have a high share of foreign participation in their local government bond markets.
- There is a broad convergence across the 5 countries in terms of growth and foreign borrowings by the corporate sector. All have moderate growth prospects, with weakness in the global economy. Further, external borrowings by the corporate sector remain high across all the 5 countries.
- Finally, this report examines *susceptibility* to an event risk, and not its *likelihood*.

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Emerging Markets: Currencies and Equities

- There has been a general downtrend in Emerging market equities and exchange rates through 2015. However, this has quickened over the past 3 months.

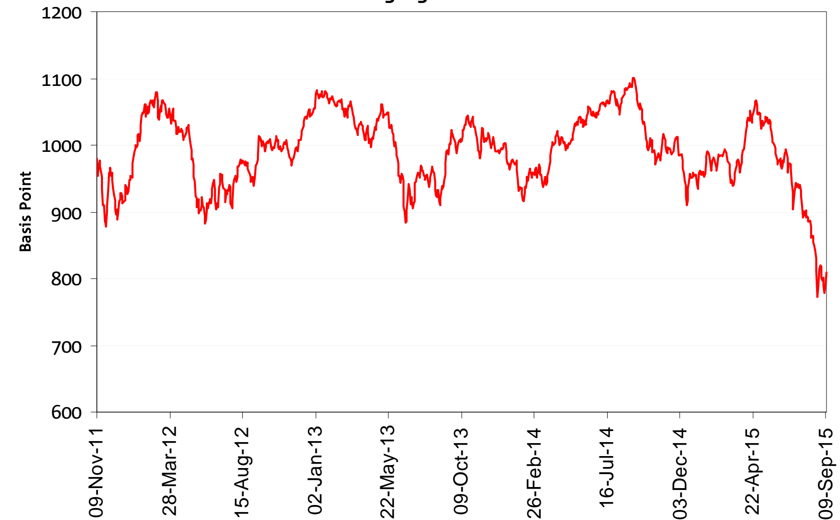
- The *MSCI Emerging Markets* Index has fallen about 17% over the past 3 months. The sharp falls in the *Shanghai Composite* Index, along with the devaluation by the PBOC (People's Bank of China) on the 11th of August have had a significant impact on EM equities. More recently, there has been an improvement, following suggestions the Chinese authorities might accelerate infrastructure spending.

- There have been declines over the past 3 months across all 5 EM Asian countries, led by Indonesia, and Taiwan at -11%, -10% respectively. Malaysia fell by 7%, while South Korea and Thailand contracted by 6%.

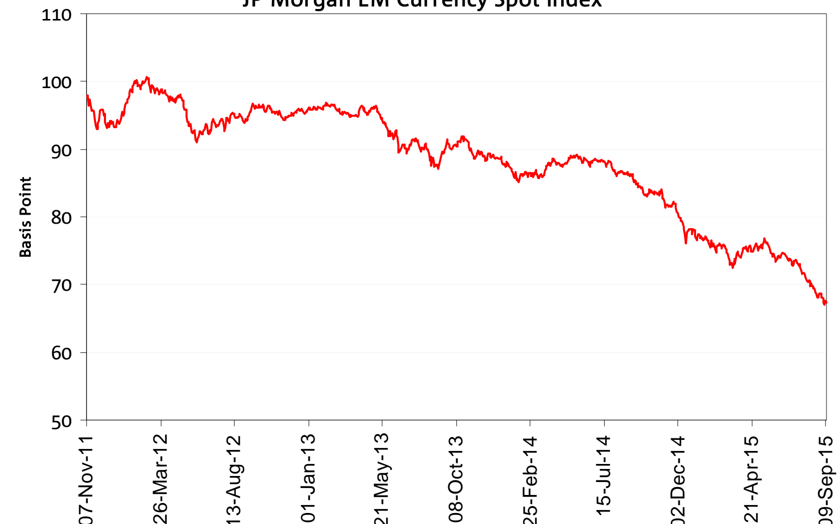
- Separately, the *JP Morgan EM Currency Spot* Index, fell 9% over the past 3 months.

- While EM currencies have fallen, there has been a limited improvement in export volumes. According to research conducted by the *Financial Times*, weaker currencies have led to lower imports, rather than higher exports. *The analysis found that for a 1% depreciation of the local currency against the USD, import volumes fell, on average, by 0.5%.* Thus the real challenge is one of soft global demand; trying to boost exports through weaker currencies might only have a modest impact on exports.

- *Further, there is a nexus between weaker equities, falling currencies and outflows from EM markets. This stems from waning investor appetite for EM securities. How long this lasts will determine both returns from EM as an asset class, as well as growth prospects for EM markets.*



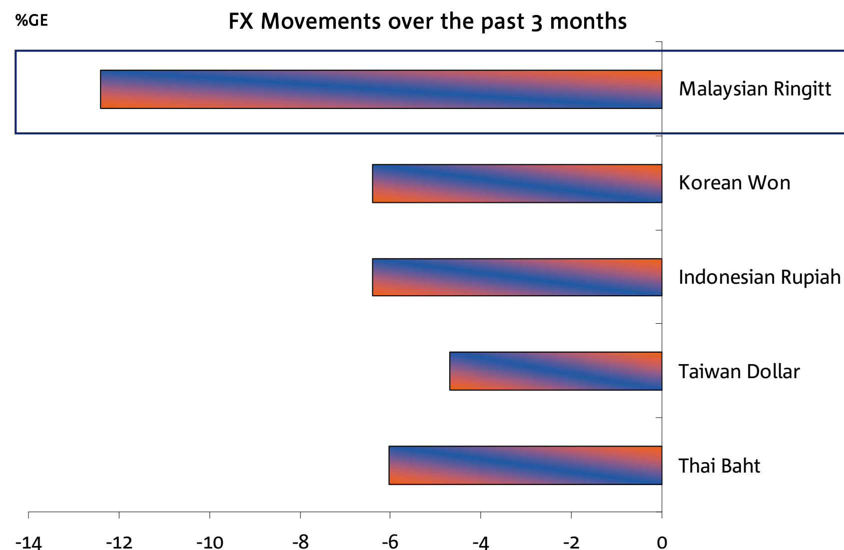
Source: Bloomberg

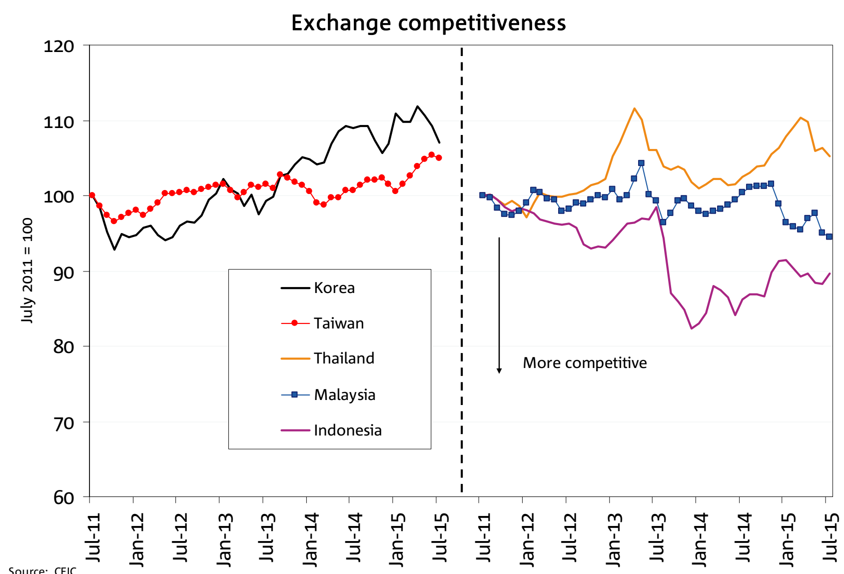


Source: Bloomberg

Asian Currencies

- There have been declines in Asian currencies over the past 3 months: the Taiwan Dollar (-4.7%); Thai baht (-6%); Korean Won and Indonesian Rupiah (both -6.4%) all declined.
- However, the steepest decline was in the Malaysian Ringitt which fell by -12.4%. This could be due to political uncertainties in Malaysia, and possibly Malaysia's relatively weaker FX reserve position (see the FX reserves section).
- Flexible exchange rates can now act as a shock absorber, unlike during the Asian Financial crisis of 1997, when a number of these countries had fixed exchange rates, and experienced considerable financial instability.
- Measures of exchange rate competitiveness indicate both Malaysia and Indonesia are somewhat more competitive than 4 years' ago
- The *real effective exchange rate* measures exchange rate competitiveness. It is basically a country's exchange rate against its major trading partners, adjusted for inflation. A higher rate indicates lower competitiveness.
- The real effective exchange rates of Thailand and Taiwan are 5% higher than 4 years' ago, but are heading down. South Korea's real exchange rate has risen by the most, 7% higher. However, all these countries run Current account surpluses, which somewhat explains the stronger rates. Further, the real exchange rate is heading south in all of the above countries, driven largely by weaker nominal rates.
- The NAB Asia team has lowered its FX rate forecasts for the Emerging Asian nations, with further declines possible.





Capital Flows

- According to *EFPR Global*, there have been USD44bn of outflows from Emerging market equities and bonds since mid-July.

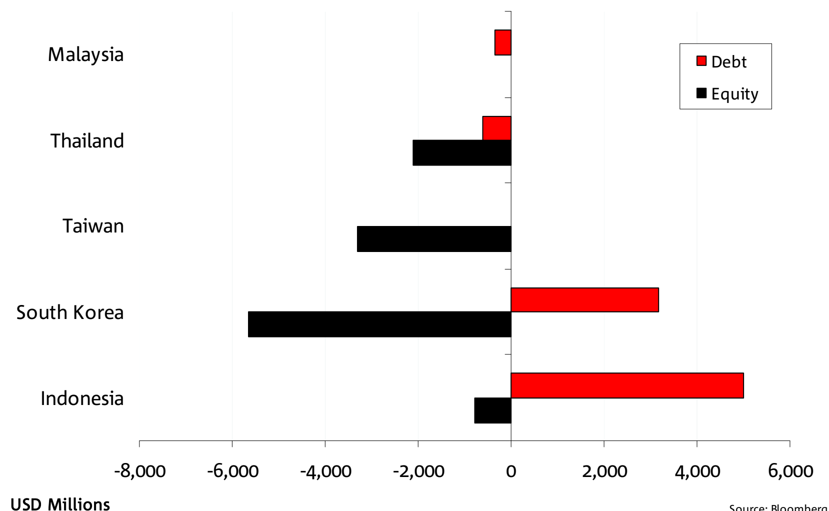
- In Emerging Asia, this trend is clearly seen in equity outflows. Over the past 3 months, there have outflows from across the major Asian emerging markets: South Korea (-5.7bn USD), Taiwan (-3.3bn USD), Thailand (-2.1bn USD) and Indonesia (-771m USD). The steep declines in South Korea and Taiwan reflect their strong trade dependence on China and are also mirrored in their equity market performance.

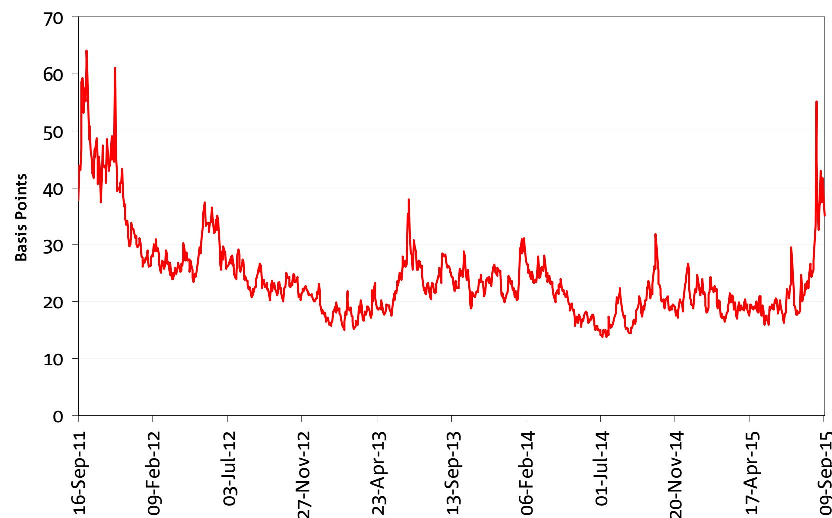
- This pattern has, thus far, not been reflected in debt flows, which largely remain positive. This is also confirmed by data from the *Institute of International Finance*, which found that net inflows of bonds to Emerging markets were 4.2bn USD in August, in contrast to net outflows from EM equity market of -8.7bn USD.

- South Korea (3.2bn USD) and Indonesia (5bn USD) experienced a high level of bond inflows. Conversely, there were modest outflows from Malaysia (-607m USD) and Thailand (-358m USD). Foreign investors pulled out funds from *both* debt and equity markets in Thailand.

- The trend of portfolio outflows (particularly in equities), reflects a 'risk off' environment. With the Fed's anticipated rate rise, and concerns about a slowing China's and its resultant impact on Emerging markets, investments in Emerging markets have lost some of their allure, compared to the post-GFC environment when the US Federal Reserve's QE program was in full swing.

- In fact, EM outflows tend to increase with rising levels of volatility, as indicated by the EM Volatility index. Rising global uncertainty (higher VIX) and global growth fears tend to precipitate outflows from Emerging markets.





China Export Dependency

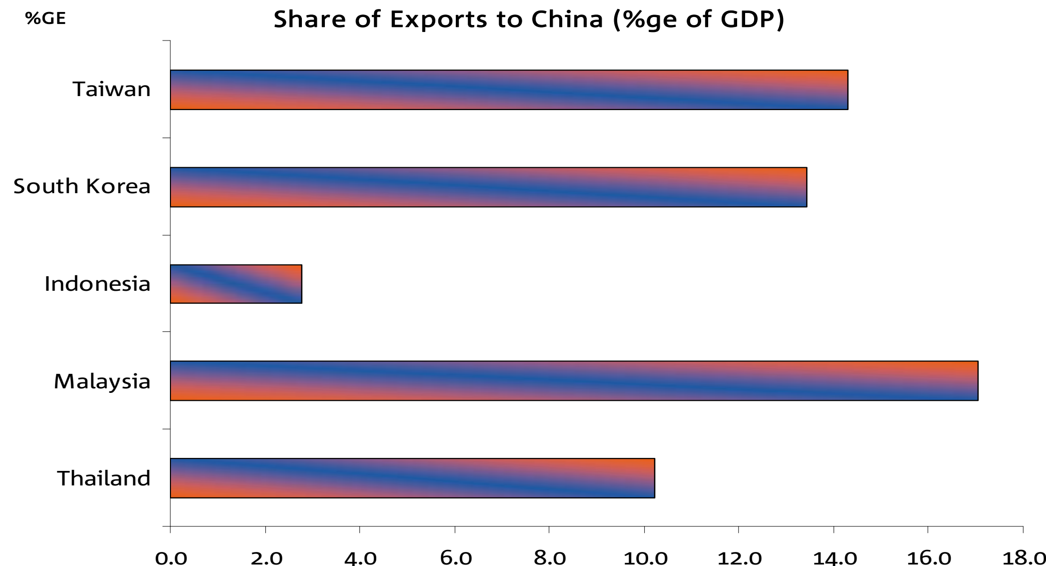
- *According to research from the IMF, a 1% fall in Chinese GDP leads to a 0.3% fall, on average, in other Asian countries the following year.*

- Trade is one of the key channels for the transmission of economic shocks through the region. Taiwan, South Korea, Thailand and Malaysia are highly dependent on exports to China, with exports to China in each of these countries exceeding 10% of nominal GDP. Indonesia is somewhat less exposed, given its large domestic market, and the fact that Japan is its largest export market. However, it too, would be impacted by a slowdown in China.

- For countries such as South Korea, major corporations such as Samsung and Hyundai consider China to be among their most important export markets. Hence, a slowdown in Chinese economic growth, and/or a weaker Yuan would have a negative impact on these companies.

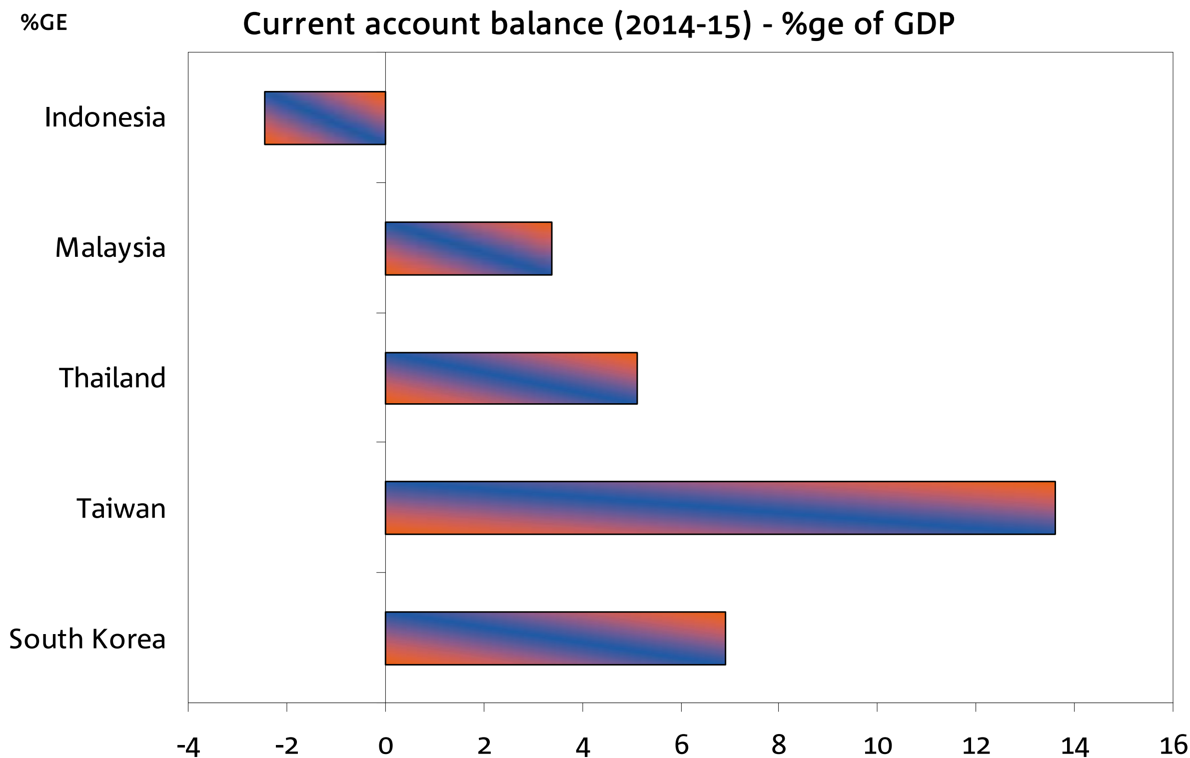
- Further, China is also making strides in the manufacture and export of products such as telecommunication equipment, shipbuilding and electronics, which will put further pressure on companies in South Korea, Taiwan and Malaysia among others. Further afield, German manufacturers will be exposed from a China slowdown, as companies such as Volkswagen count China as a key export markets.

- Finally, on the issue of commodities, both Indonesia and Malaysia are more exposed to the current downturn in commodity prices, with exports of mineral fuel and related products, accounting for over 10% of their merchandise exports.



Current Account Positions

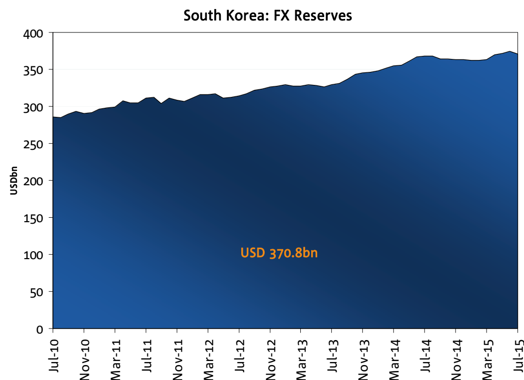
- Current account balance basically measure a country's need for funding from abroad. For countries running a deficit, there is a need to borrow from overseas. Conversely, countries with a positive balance, are able to lend overseas.
- During the 'taper-tantrum' of 2013, countries with a current account deficit fared worse than those with stronger positions.
- Taiwan (13.6% surplus, as a ratio to GDP) has the strongest current account position, followed by South Korea (6.9%). Thailand (5.1%) and Malaysia (3.4%) also maintain surplus positions.
- Indonesia, on the other hand, has a modest current account deficit (-2.4%).

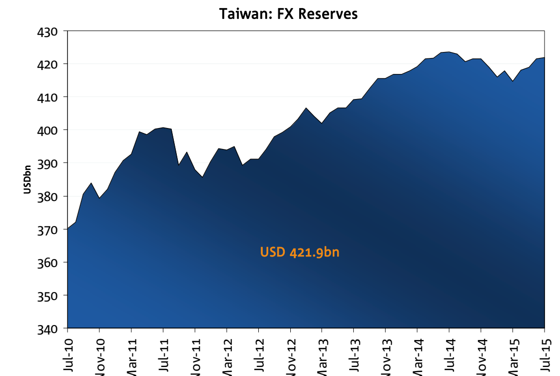


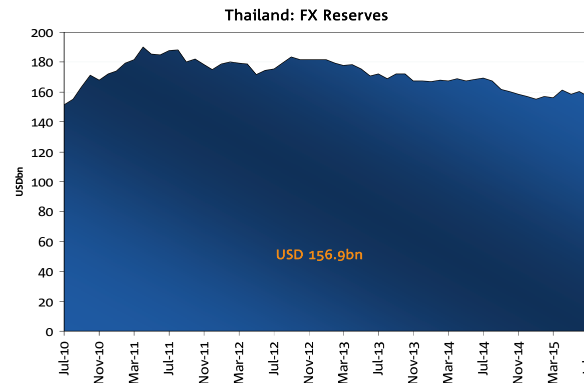
Source: CEIC

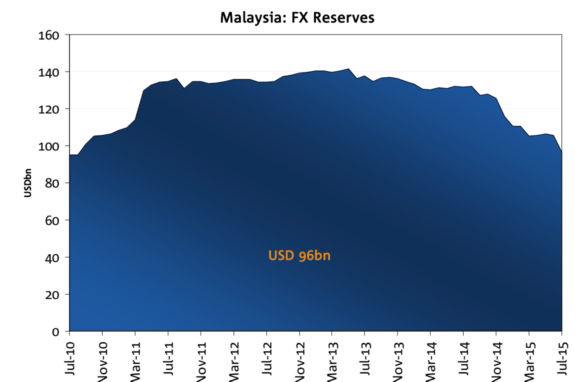
FX Reserves

- The level of FX reserves helps provide economies with critical support in the event of economic shocks. Central banks can use their reserves, for example, to defend their currency from speculative attacks.
- Further, evidence from the GFC indicates that countries with higher levels of accumulated FX reserves tended to experience stronger post-crisis growth (Dominguez, Hashimoto and Ito).
- In Emerging Asia, Taiwan (USD 421.9bn) and South Korea (USD 370.8bn) clearly stand out from the rest.





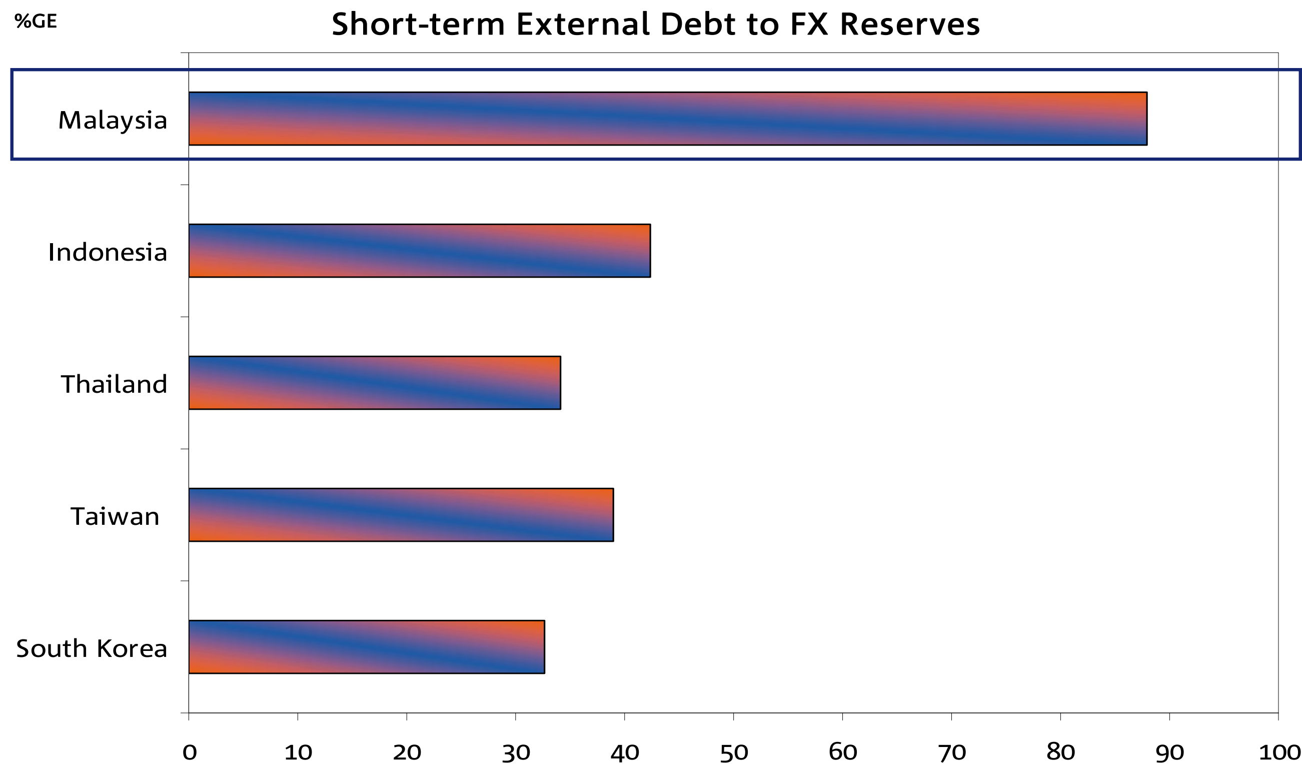




Source: IMF, Bloomberg

Short-term External Debt

- The level of FX reserves is a crucial determinant of a country's ability to cope with a crisis.
- This assumes added significance if we consider FX reserves in relation to the level of Short-term external debt.
- The ratio of Short-term external debt to FX reserves is a measure of external liquidity stress, and provides an important metric to assess a country's external strength, or otherwise.
- By this measure, South Korea (32.7%) is the best performer. Thailand (34.1%), Taiwan (39%) and Indonesia (42.3%) also fare reasonably well.
- Conversely, Malaysia is a concern, with the ratio a high 88%.



Source: IMF

BIS Claims: Short term (Up to 1 year)

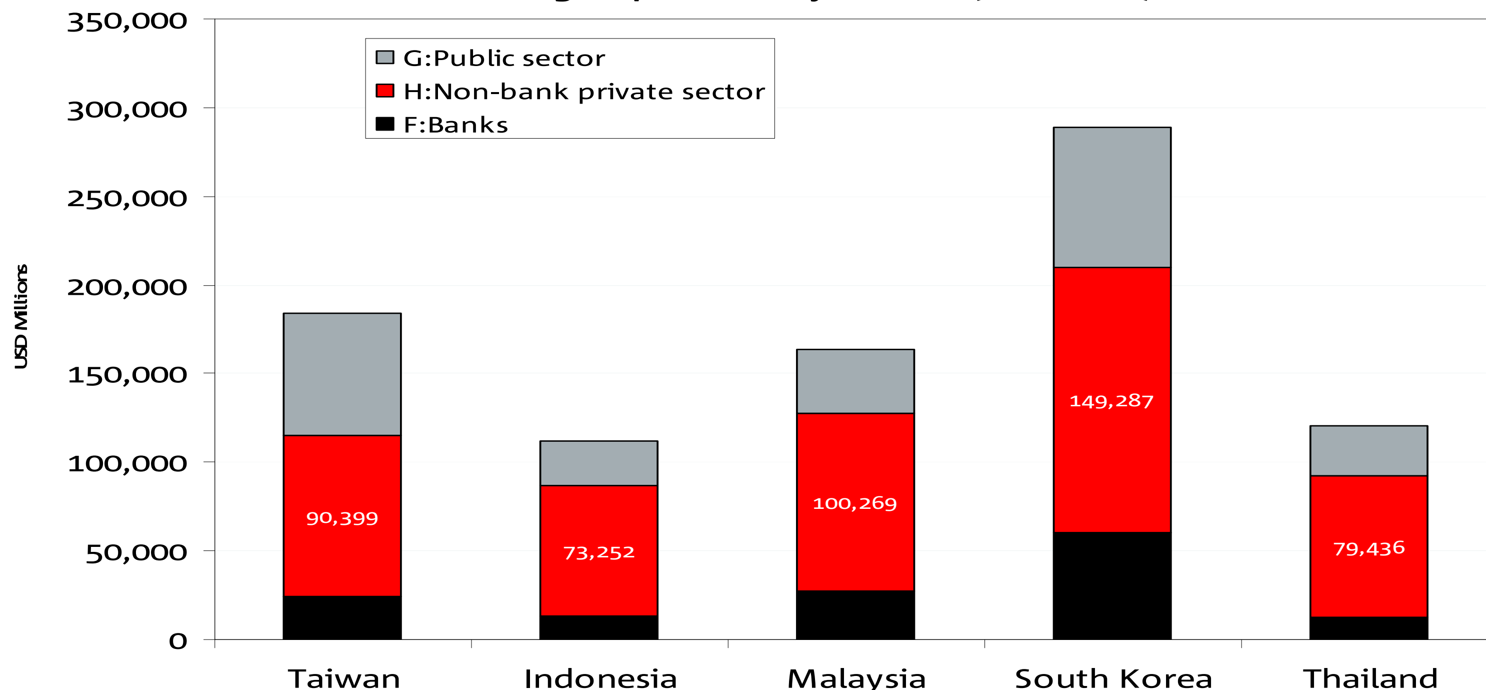
International Claims up to 1 Year from BIS Banks: USD Millions

	Taiwan	Indonesia	Malaysia	South Korea	Thailand
2015-Q1	89,413	56,206	33,439	113,923	17,662
2014-Q4	96,324	57,744	37,285	116,811	19,226
2014-Q3	109,095	54,314	40,462	121,106	20,650
2014-Q2	102,385	54,136	42,025	129,971	20,858
2014-Q1	102,227	53,737	38,501	118,892	19,564

Source: BIS

- Short term claims (up to an including a year), also provide a good indicator of short-term liquidity risks. By this measure, South Korea (USD 113.9bn) and Taiwan (USD89.4bn) look more exposed. Both these countries (particularly Taiwan) have reduced their short term risk profiles.
- Indonesia, whilst considerably lower than South Korea and Taiwan, has modestly increased its short term borrowings from BIS banks.
- Malaysia and Thailand have lower levels of borrowings, and both have reduced their reliance on short-term foreign borrowings.

BIS Claims: Overall



Source: BIS

- Examining overall exposures (both short and long-term), shows that both South Korea and Taiwan have higher levels of borrowings from BIS Banks.

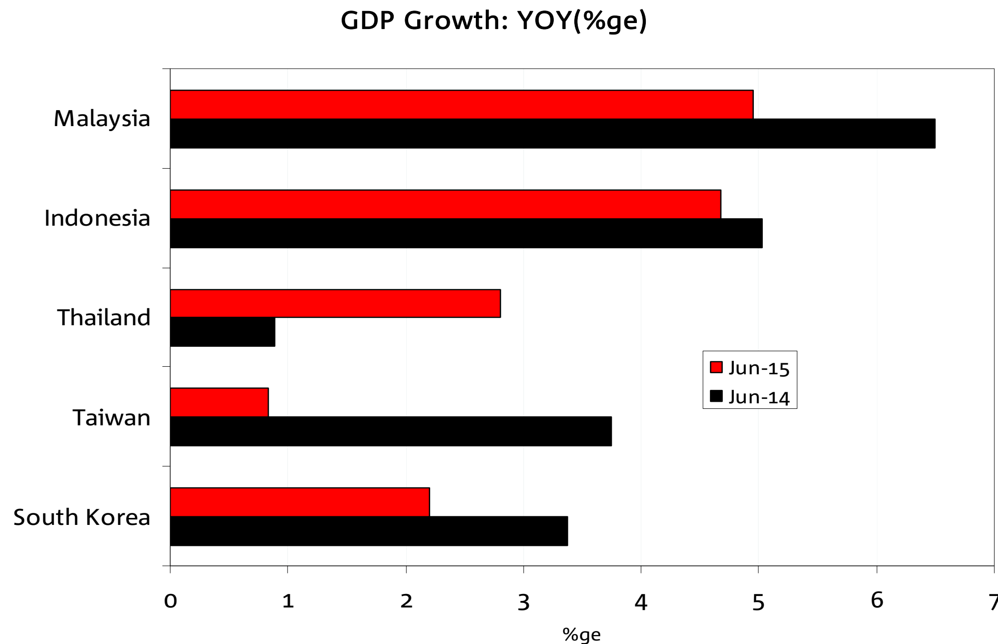
- *The Non-bank private sector is the segment with the most foreign borrowings. South Korea (USD149.3bn) has the largest exposure among the countries, all the countries' non-bank corporate sector have high levels borrowings, including Malaysia (USD100.3bn), Taiwan (USD90.4bn), Indonesia (USD73.2bn) and Thailand (USD 79.4bn).*

- High levels of borrowing do generate rollover and currency risks. While some multinational corporations (e.g. Samsung) have foreign revenue streams which can act as a natural hedge, not all corporations have this facility.

- *Further, corporations with unhedged foreign exposure would be most at risk in the event of a sharp appreciation in the US dollar relative to their own domestic currency.*

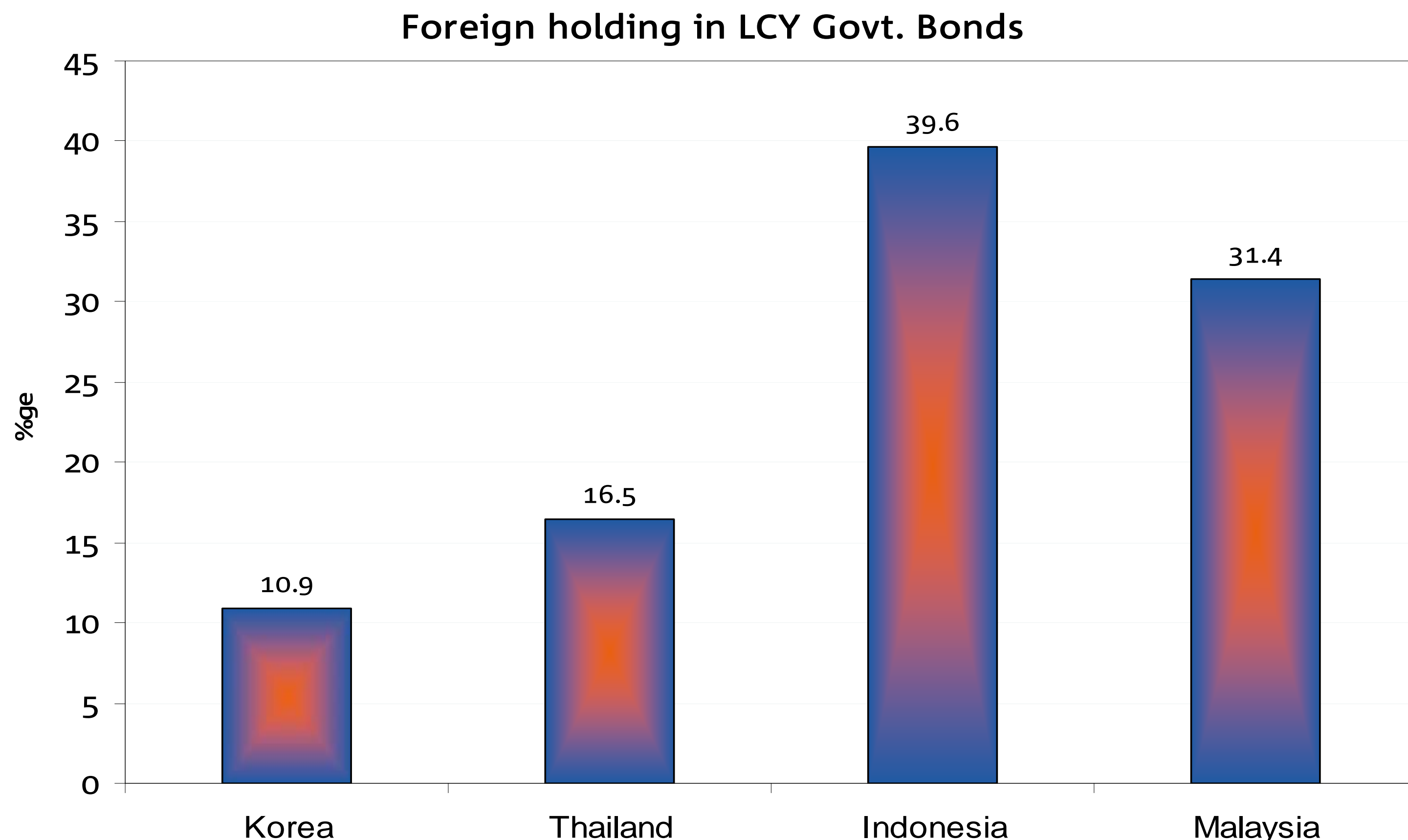
Recent Growth performance

- Growth has been quite sluggish across the Emerging Asian countries over the past year, weighed down by softer world trade (exports), and modest domestic demand.
- The exception is Thailand, which has witnessed an improvement from last year's slump, triggered by political uncertainties.
- Leading indicators such as the *Manufacturing PMIs* (Purchasing Managers' Index) point to weak near-term outcomes across the Emerging Asian region: South Korea (47.9); Taiwan (46.1); Indonesia (48.4); and Malaysia (47.2).
- Inflationary pressures remain muted across most of Emerging Asia. The exception is Indonesia, with headline inflation expanding by 7.3% over the year to July, indicating a need to maintain a tight monetary policy stance.
- Overall, Emerging Asian countries are better off than countries such as Brazil which has to grapple with recessionary conditions and high levels of inflation.



Bond market: Share of overseas participation

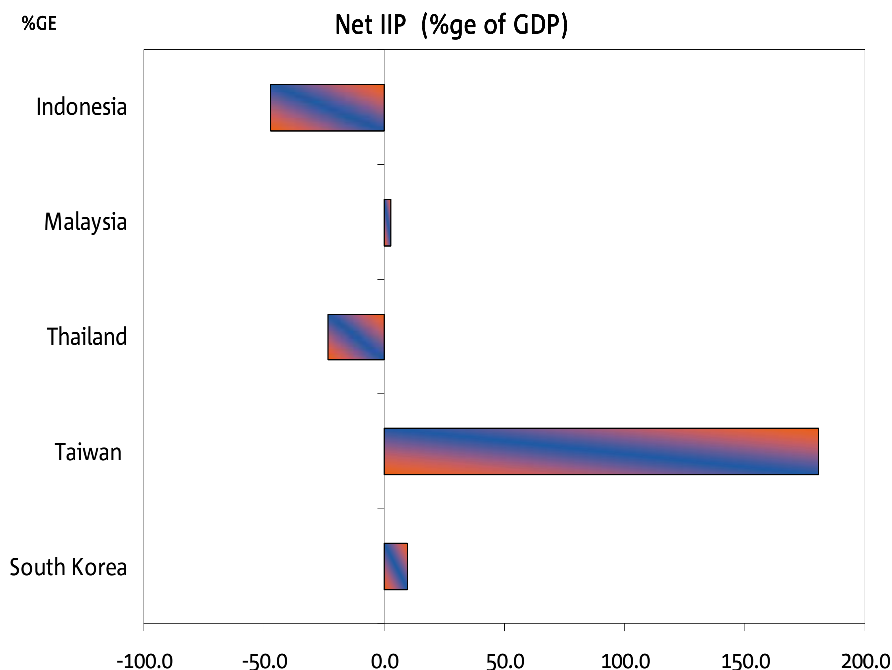
- Countries with a high proportion of foreign investors in their bond markets are more likely to experience capital flight or sudden stops in times of global uncertainty.
- Further, these countries are more likely to experience contagion from risks emanating in other emerging markets.
- According to the *Asian Development Bank*, there are substantial foreign holding in the Local currency government bonds of both Indonesia (39.6%), and Malaysia (31.4%), suggesting they are more at risk of capital outflows.
- On the other hand, South Korea (10.9%) and Thailand (16.5%) are somewhat less exposed to changes in foreign investor perceptions.



Source: ADB

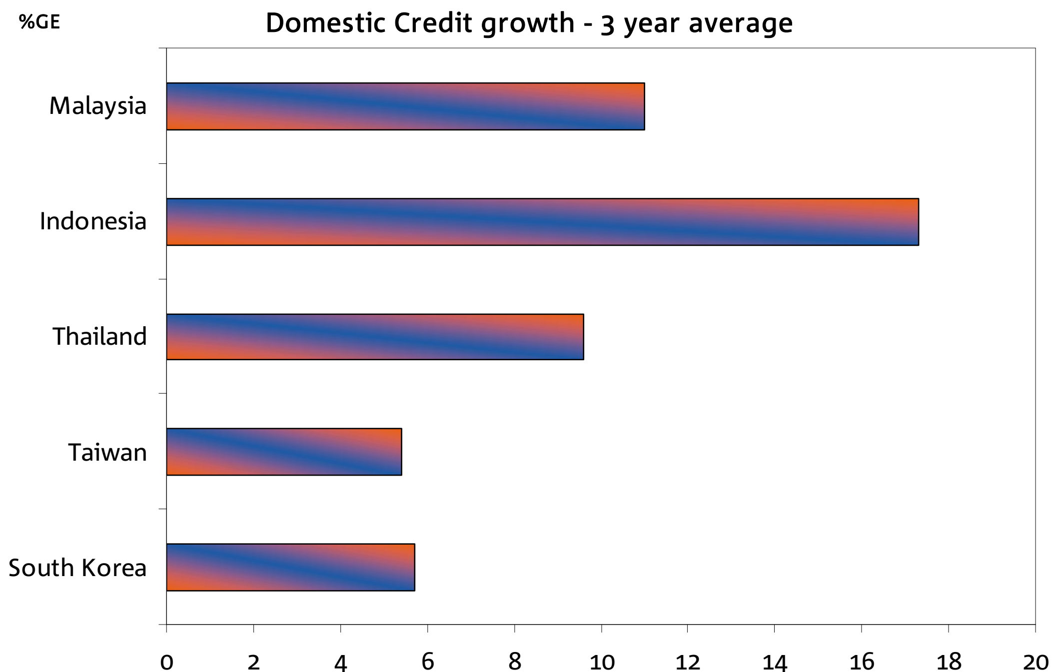
International Investment Position

- The International investment position (IIP) is a measure of a country's net foreign assets. Countries with a positive net IIP are, in effect, net foreign creditors. Those with a negative position, are net foreign debtors.
- Those with a positive net IIP can draw down on their overseas assets in times of crisis. On the other hand, those with a significant net IIP deficit could find their overseas debts burgeoning with adverse movements in the exchange rate.
- Among the Emerging Asian countries, Taiwan stands out with a high (and positive) net IIP: 180% of GDP. South Korea's net IIP position is also strong at 9.5% of GDP. Malaysia has moved slightly into a net surplus position, at 2.7%.
- Thailand(-23.6%) and Indonesia(-47.4%) are both net overseas debtors.



Domestic credit growth

- The pace of credit growth can also be an indicator of mounting stress.
- In the event of a global shock, high past credit growth can lead to increased levels of non performing loans. The latter can generate problems for the banking system, exacerbating any potential economic downturn.
- In terms of credit growth (based on the 3-year average), both Malaysia and Indonesia have recorded growth rates in credit in excess of 10%, with credit growth strongest in Indonesia.
- Thailand's average is close to, but slightly below, 10%.
- Both Taiwan and South Korea have recorded credit growth below 6%.



Source: Moody's

Governance & Business Climate

- In terms of *Governance*, Taiwan (79th percentile) and South Korea (73rd percentile) remain the strongest among the Emerging Asian economies. Both have a good regulatory framework, and effective Government administration. South Korea is hindered somewhat in the area of political stability.

- Malaysia (62nd percentile) comes in next, followed by Thailand. Regulatory quality and Government effectiveness (legal framework, limited waste) are high in Malaysia. Thailand does somewhat better in controlling corruption.

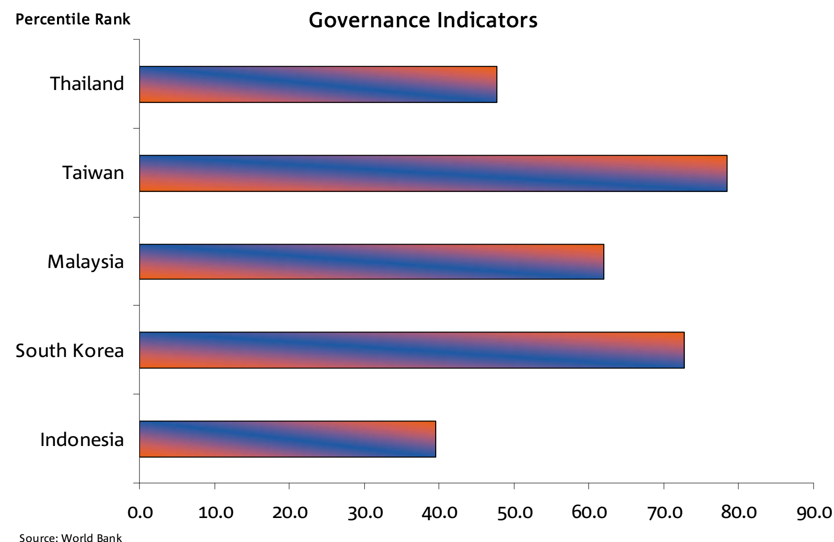
- Indonesia is the weakest (40th percentile) among the Emerging Asian countries, with poor results in political stability, rule of law and corruption. Voice and accountability and regulatory quality (limited burden from Government regulation) were somewhat better performing areas.

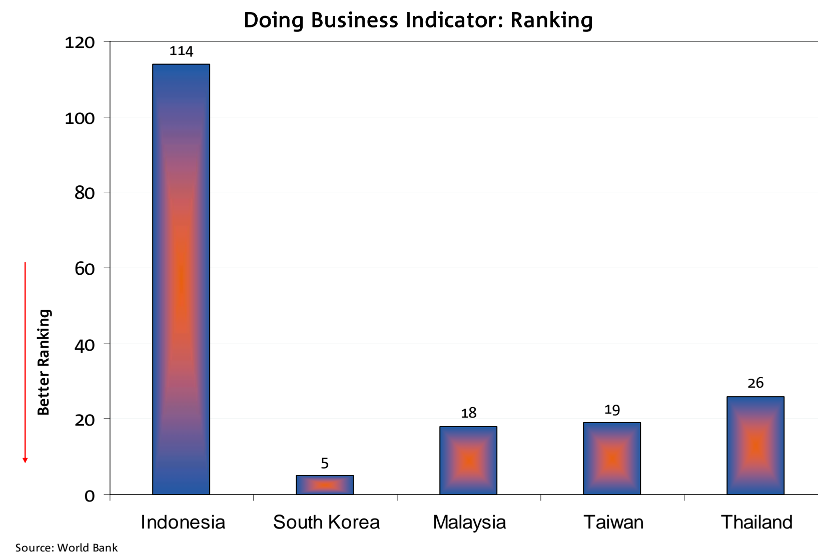
- Turning to the business climate, the World Bank's *Doing Business Indicator* ranks South Korea 5th in the World, out of a total of 189 countries. Its particular strengths lie in enforcing contracts, trading across borders and resolving insolvency disputes. The high quality of education and technological adoption make it a very innovative economy.

- Malaysia (18th) and Taiwan (19th) also fare strongly. Malaysia strengths lie in Trading across borders, and Minority investor protection. Taiwan's strength are in resolving insolvency and dealing with construction permits.

- Finally, Indonesia (114th) is the laggard, with difficulties in enforcing contracts, commencing a business and the taxation regime.

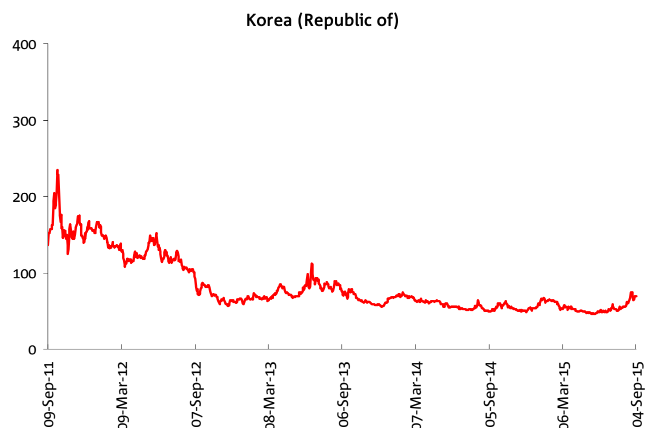
- However, Indonesia does have strengths. These include: the large market size, the state of industrial cluster development and the breath of the value chain.

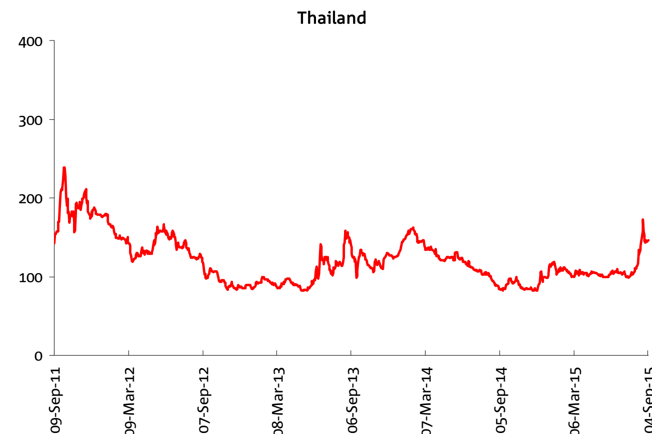


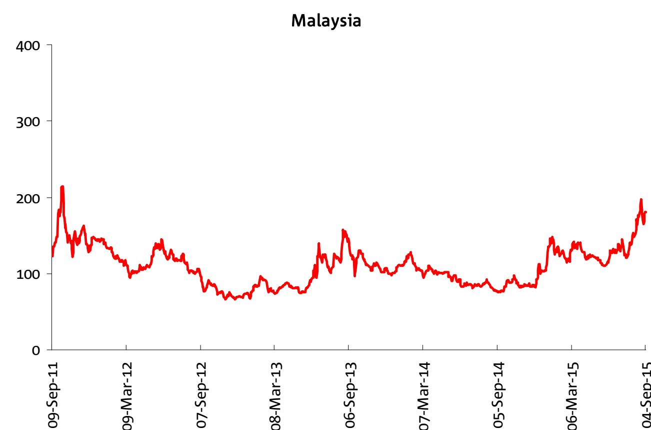


CDS Spreads

- A Credit default swap measures the cost of insuring the sovereign's credit question; for example, a sovereign spread of 50bp indicates that a CDS purchaser will need to pay the seller $50,000 on a $10 Million contract to insure against credit risk.
- It can be thought of as a market measure of default risk.
- In the Emerging Asian space, there has been a discernable increase in risk spreads since the 3rd week of July – possibly driven by contagion fears surrounding China. These have pulled back a little since then.
- The rise in spreads have occurred mainly in Thailand, Malaysia and Indonesia. South Korea does not seem to be as impacted.
- CDS markets consider South Korea to be the least risky, (69bps).
- Thailand (146bps) came in next, followed by Malaysia (183bps).
- Indonesia is considered to be the most risky (238bps) in the Emerging Asian region.







Concluding remarks

- Emerging Asian countries are better off than when the Asian Financial Crisis struck in 1997. Unlike 1997, they have the natural shock-absorption of flexible exchange rates, and have substantially built up their foreign exchange reserves.
- However, there are challenges on the horizon, with concerns about the strength of Chinese growth, and the potential negative impact of the expected rise in the US Fed funds rate.
- There have been falls in EM currency and equity markets, as well as portfolio outflows, particularly for equities over the past 3 months.
- An indicators system is used to asses the resilience of the 5 Emerging Asian economies to external shocks. These economies include: South Korea, Taiwan, Thailand, Malaysia and Indonesia.
- Among the major Asian Emerging economies, South Korea and Taiwan, appear stronger than the rest. Both of them run current account surpluses, have high levels of foreign exchange reserves and maintain positive net foreign assets. The strong net foreign assets for Taiwan is particularly striking.
- Conversely, both of the above countries are likely to be strongly impacted by a slowdown in China, as China accounts for a significant share of their exports.
- At the other end of the spectrum, Indonesia runs a current account deficit and is a net external debtor. However, its foreign exchange reserves are reasonable, and it is somewhat less exposed to a potential downturn in China.
- Malaysia and Thailand both run current account surpluses, but differ on other critical metrics. Malaysia is a net foreign creditor, unlike Thailand. However Malaysia's foreign reserves are less than adequate; in contrast, Thailand's reserve coverage is adequate.
- Indonesia and Malaysia are both highly dependent on commodity exports, and both of them have significant foreign participation in their domestic government bond markets.
- There is a broad convergence across the 5 countries in terms of growth and foreign borrowings by the corporate sector. All have modest growth prospects, with weakness in the global economy. Further, external borrowings by the corporate sector remain high across all the 5 countries.

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