FX STRATEGY *Thematic*

Asia's road out of Globalization's retreat

- **The year of the Fire Rooster sees the dawn of a period of uncertainty as protectionism rears its head and threatens the global economy.**
- **Given that environment, it might be just as well that the Year of the Rooster is associated with the qualities of industry, resourcefulness and courage: many Asian countries will need a healthy dose of all 3 to outmaneuver these difficulties.**
- **The response that many will take will probably involve addressing longstanding infrastructure bottlenecks, before these problems really come home to roost.**

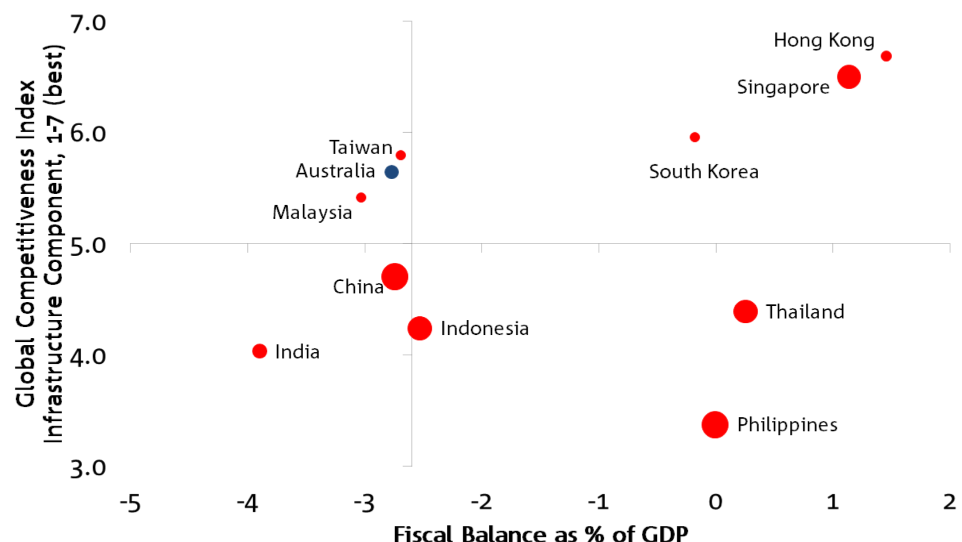
Build it and they will come

For sure, some Asian countries have already got an early start – Singapore has been adding capacity and reach to its intra-city train system, and China has begun to do the same for its regular and high-speed inter-city network – but other countries have a much larger gap to bridge.

The economies in the lower half of the chart below generally could use some sprucing up of their infrastructure facilities while those in top half generally have relatively strong infrastructure capacity and need to be more selective about spending. This is especially so for those in the top left quadrant, where fiscal deficits are already substantial. Those in the bottom right have the need to spend and the wherewithal to do so.

Across the economies in the bottom half of the chart, almost all have budgeted increases in fiscal expenditure. Not all are letting that feed into budget deficits though – the Philippines for example is looking at raising taxes to keep the deficit in check but still fund increased spending on infrastructure. China, Indonesia and Thailand though are widening their deficits marginally, at least partially to fund more infrastructure investment. All this will very likely translate into increased demand for industrial metals and other hard commodities, which should at least support prices for these. As geographically the nearest large commodity exporter, Australia is well positioned to benefit from this robust demand. The Year of the Rooster might afford Australia something to crow about!

Chart 1: Increased infrastructure spending is likely in some parts of Asia



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Asia's infrastructure needs are well hatched

Recent estimates cited by the Asian Development Bank (ADB) in its 2016 report suggest that Emerging Market Asia will need to increase infrastructure spending substantially to meet the demands of rapid urbanization and economic growth. One of these, by Bhattacharya et al (2012), projects that spending would need to rise from around USD 800-900 billion (around 3% of GDP) then to USD 1.8-2.3 trillion (6%-8% of GDP); this includes climate change mitigation spending of USD 200-300 billion a year. Of the increase, East Asia and South Asia would account for the vast majority. Another estimate done by PWC in 2014 projected infrastructure spending in the Asia Pacific region growing 7%-8% to reach an annual volume of USD 5 trillion by 2025; the PWC definition though also includes mining activities and key manufacturing that supports transport and utilities activities.

The World Economic Forum's Global Competitiveness Index includes a survey of the quality of infrastructure worldwide and it seems to concur with the ADB's findings. The index covers both transport infrastructure, and electricity & telephony infrastructure. On a scale of 1-7, with 7 being the best, East Asia and the Pacific registers 4.78 for overall infrastructure and South Asia registers just 3.18. Australia, by comparison, comes in at 5.65, with the city states of Hong Kong and Singapore topping the list at 6.69 and 6.50. Bringing up the rear are India, Indonesia, Thailand and the Philippines, all registering under 4.40. Even China comes in at just 4.71, suggesting that there is still significant room for improvement. These relative levels are also seen in both the two sub-areas, although the dispersion is much higher for electricity & telephony infrastructure.

Table 1: Global Competitiveness Index Infrrastructure sub-component rankings

World ranking out of 138 countries (lower = better)	Transport infrastructure	Electricity and telephony infrastructure
Australia	19	14
China	18	75
Hong Kong	3	1
India	24	106
Indonesia	36	81
South Korea	10	16
Malaysia	11	46
Philippines	90	95
Singapore	2	5
Taiwan	16	15
Thailand	37	73

Source: National Australia Bank, World Economic Forum

A halting response, despite some early birds

Despite having started early, both **Singapore** and **China** have embarked on multi-year build outs of the respective rail systems. **Singapore** continued the work that it had begun on its Mass Rapid Transit (MRT) system in 2011; Singapore is aiming to have a train station within 10 minutes walking distance of 80% of households by 2030, from 60% in 2015. By 2030, the target is a doubling of the rail network to 360km, with a density rivalling networks in London, New York and Tokyo.

China meanwhile finally started on its plans of having its rail network cover80% of its major cities nationwide by 2020, with cities with a population of at least 200,000 being linked by regular rail and those with at least 500,000 linked by high speed rail (HSR). This target would require spending of RMB 3.5 trillion (USD 503 billion) and imply an 18% increase in the total length of regular rail and a 58% increase in HSR from 2015; further increases of 14% and 27% respectively are projected for 2025 over 2020.

Table 2: China's planned rail network expansion

	Regular Rail (km)	Growth rate (regular)	High Speed Rail (km)	Growth rate (high speed)
2015	102000		19000	
2020	120000	18%	30000	58%
2025	137000	14%	38000	27%

Source: National Australia Bank, State Council of China

Beyond these 2 early birds, the others in the bottom half of the chart, especially the 3 Southeast Asian economies of **Indonesia, Thailand** and **Philippines**, do have plans to start beefing up their infrastructure capacities. **Indonesia**, for example, in October 2015 awarded the rights to build a USD 5.5 billion railway line that will connect the capital Jakarta to Bandung; the line is set to begin operation in H1 2019. **The Philippines** meanwhile has just announced plans to increase infrastructure spending from 3.5% of GDP this year to 5.7% by 2022; 64 major projects are currently underway with 43 of these involving roads and railways. Both Indonesia and the Philippines are likely to be fairly willing to push strongly for increased infrastructure spending given that their debt positions have improved sharply over the last decade or so, with sovereign ratings of both having been elevated to investment grade by all major ratings agencies.

Thailand has both the fiscal room to improve fiscal spending and the need to, both on a structural and cyclical basis. While the government has announced that 36 infrastructure projects worth USD 25 billion will begin this year but more might be on the cards. Most notably, Thailand sits at the heart of the ASEAN Economic Community's (AEC) ambitious plan to build a high speed rail corridor from Singapore to Kunming in southwest China, along with an east-west arm connecting Myanmar to Vietnam. The Singapore-Kuala Lumpur (capital of Malaysia) leg of the rail corridor is set to begin construction this year and China and Thailand agreed late 2016 on the first phase of the 873km section linking Thailand to Kunming. The 250km first phase linking Thailand and neighbouring Laos is projected to cost USD 5.15 billion. The AEC's rail corridor is also set to be part of China's ambitious One Belt One Road project to boost connectivity between China and the rest of Eurasia.

Budget constraints though could keep **India's** fiscal ambitions in the coop. Although the central government has managed to keep the annual budget deficit between 3%-4% of GDP, the broader government deficit remains wide at around 7% of GDP. However, the government's attempt to push citizens to use banks more instead of relying solely on hard cash could have a disruptive impact on the economy for a few quarters and incentivize the government to increase fiscal expenditure

if it becomes clearer later in the year that revenue increases will indeed materialize fairly quickly.

Take your peck at the F-eggs basket

The impact on Asian FX though is a bit more nuanced given that politics and central bank actions will also have a part to play. Infrastructure spending could support growth to different extents, which in turn will support equity inflows. However, risk premiums, interest rate differentials, and the underlying balance of payments structure will all have a part to play.

We would be somewhat wary of the RMB due to the twin threats of continued outflows and the potential for an outbreak of trade tensions between China and the new Trump administration in the US. While the Chinese authorities are likely to keep the amount of outflows largely under control via a combination of intervention, capital controls and interbank rate hikes, the authorities are not likely to completely resist a push lower by the market if the US decides to label China a currency manipulator or impose any other punitive measures on China. These are definitely non-trivial risks and warrant wariness on the RMB.

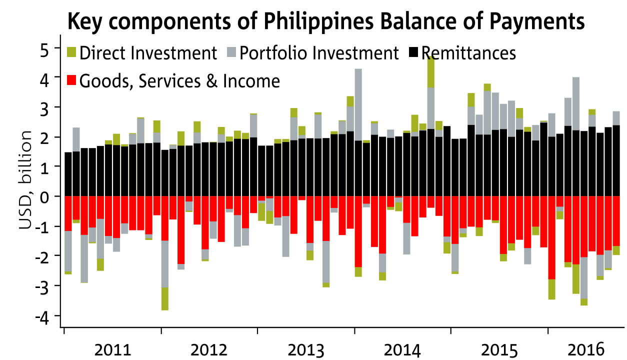
Table 3: Buffers for Asia's FX against USD strength

	NAB 2017 GDP forecasts	Current Account to GDP	Import cover (months)	6M Carry
China	6.5%	2.4%	23.7	4.5%(CNY) 4.5%(CNH)
Hong Kong	1.7%	4.2%	8.3	0.8%
India	7.2%	-0.5%	11.8	5.4%
Indonesia	4.9%	-2.1%	9.8	6.2%
Korea	3.3%	7.3%	11.0	0.7%
Malaysia	2.6%	1.9%	6.4	3.7%
Philippines	6.0%	1.0%	13.2	3.6%
Singapore	1.9%	21.7%	10.9	0.9%
Taiwan	1.9%	14.3%	22.9	-0.2%
Thailand	4.7%	12.1%	10.8	1.4%

Source: National Australia Bank, CEIC, Bloomberg

On balance, the Philippine Peso comes out looking rather resilient – growth is set to be amongst the fastest in Asia, there is still an interest rate differential and the BSP is the only central bank that can match the US Federal Reserve hikes, and the Philippines' current account surplus is especially resilient due to very stable remittance flows. The one risk with the Philippines is President Duterte's somewhat unorthodox approach to law and order, and foreign relations. While he seems to have settled down somewhat, this is still a risk going forward. Nevertheless, the prospect of this negating the Philippines' underlying structural economic strengths is just a tail risk.

Chart 2: Remittances offers the PHP strong support



Source: National Australia Bank, Macrobond

The next most attractive currency, all things considered, is probably the Indian Rupee. The Rupee's strongest attractions are probably the second highest carry in Asia and the strong growth rate, likely to be the highest in Asia. The Rupee's structural weakness is the current account deficit, although this has been kept to less than 1% of GDP. In the near term though, the uncertainty over the impact of the demonetization measures taken in November 2016 – a larger than expected negative impact could lead to some equity outflows. However, the RBI has been quite vigilant against sharp moves in either direction so relative stability is the more likely outcome. While this might also dilute prospects for potential gains, the rich carry provides decent compensation.

The Indonesian Rupiah remains a distant third choice. Although it has the highest carry in Asia (only slightly beating out the Rupee), Indonesia also has the largest current account deficit at above 2% of GDP. Growth remains significantly less impressive and the prospects of the government managing to execute on its infrastructure plans are not that good.

Thailand's political uncertainty, with elections due in H2 2017, is the biggest bugbear and more than negates its combined positives of its ability to invest and scope to benefit from infrastructure investment. Thailand's growth also remains anaemic, with both investor and consumer sentiment suppressed by the political situation. This means that the fiscal multiplier is weak so expansionary fiscal policy is unlikely to translate into strong overall GDP growth. Thailand's strong current account surplus is also somewhat exaggerated and is simply a consequence of the collapse in imports due to very weak domestic demand.

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