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Tighter global liquidity and Asia: not all gloom and doom

Asia¹ has been under pressure following from tighter global liquidity in 2018, led by a rapid pace of interest rate hikes by the Federal Reserve (Fed) of the United States (US). Narrowing interest rate differentials have led to slimmer risk premiums for investors in Asian emerging markets (EMs). This drove capital flows away from the region and into US dollar-denominated assets. Capital outflows also resulted in depreciation relative to the US dollar, leading a number of central banks in the region to hike rates and to intervene in markets to defend their currencies. The Fed is expected to continue hiking rates in 2019, which could further aggravate outflows. Our index measuring relative vulnerability to outflows points to divergence in Asia. Some markets will benefit from strong fundamentals, proactive monetary policies, and ample buffers to resist outflows. In these cases, it is likely that investors may have gotten ahead of themselves, and current valuations are not justified. However, some economies remain under pressure. Above all, the relative sustainability of the real external position remains the most significant consideration. This is a concern in cases where buffers are inadequate to cover external exposure. Lastly, countries that do not possess flexible exchange rate regimes may struggle to smooth currency fluctuations, as the reach of monetary policy is limited by the degree of dollarization of the economy.

Global monetary policy tightening has been draining liquidity from Asian markets

Global growth picked up in 2017, putting an end to a period of unprecedented monetary stimulus, which started with expansionist policies put in place after the global financial crisis in 2008. Central banks are now resuming monetary policy normalisation, hiking policy rates to avoid overheating, but also in order to rebuild their arsenals for future crises. For example, the Fed has hiked interest rates by 175 basis points (bps) to 2.50% since February 2017. The pace of normalisation picked up significantly in 2018, with the last hike having taken place in December. However, monetary policy

normalisation has drained liquidity from financial markets, which impacts Asian EMs. When the Fed hikes, interest rate differentials narrow, resulting in slimmer risk premiums. This drives capital flows away from the region and into US dollar-denominated assets (**Chart 1**). To this accord, the International Institute of Finance (IIF) forecasts that net portfolio inflows to emerging markets (ex-China) will slow by 30% in 2018 – almost back to 2016 levels².

To limit the risks associated with outflows, central banks in the region – including the Philippines, India, Indonesia, Malaysia and Sri Lanka – have been forced to follow the tightening stance of monetary policy set by the US, despite being in very different stages of their respective

1 - Excluding China, Japan and South Korea

2 - Capital flows to emerging markets looking past the turbulence, Institute of International Finance, October 2018

business cycles. In addition, outflows have also exerted pressure on foreign exchange, another important asset class. Asian EMs have experienced depreciatory pressures during most of 2018 (**Chart 2**). To relieve pressure on the external position, central banks – including those of the Philippines, Indonesia, and India – intervened on currency markets to smooth exchange rate fluctuations. Indonesia and Pakistan’s governments also took measures to limit imports in order to counter pressures induced by widening trade deficits resulting from weaker currencies. All of this has brought back memories of past instances when the region struggled with portfolio outflows, namely, the Asian Financial crisis of 1997 and the “Taper Tantrum” of 2013.

Resilience to such shocks has increased, but some exposure remains

Despite these similarities, the region is, for the most part, in a better position to resist outflows. Exposure

to external pressures has been greatly reduced over the last two decades, especially since 1997. Floating exchange rates have been adopted across the board and can now absorb exogenous shocks. This reduces the need for central banks to spend foreign exchange (FX) reserves to defend their currencies. Myanmar was the last country to adopt a flexible FX regime, when it removed the trading band that was used to manage the value of the kyat in August 2018. Moreover, most of the Asian EMs have turned their current account deficits into surpluses. In the cases where large structural trade deficits persist, it has so far been financed by a dequate Foreign Direct Investment (FDI) inflows (**Chart 3**), especially in the cases of the Philippines, Cambodia, and Laos. Expatriate remittances have also played a role in some cases, such as in the Philippines and Sri Lanka, where the trade deficit is largely compensated by remittances (representing 10% and 8% of GDP respectively).

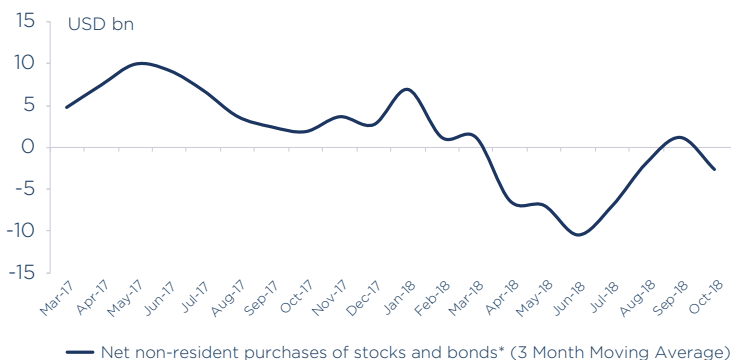
The surplus of the basic balance (including the current account and FDI) has been providing valuable FX reserves to counteract the potential risks associated with capital flight or foreign debt in most cases. FX reserves can play an important role in servicing short-term debt, thus avoiding a Balance of Payments (BOP) crisis and reducing external pressures. Pakistan experienced such an instance in 2018, when it ran out of resources to cover its short-term debt repayment costs. Other countries with FX reserves at or below the adequacy benchmark (three months of imports) include Laos, Myanmar, and Vietnam (**Chart 4**).

FX reserves can be used to finance the external position, but this is not sustainable if external debt is high. Although a study by the Asian Development Bank Institute (ADBI) concluded that external debt levels in Asian countries are sustainable over time⁴, some exceptions are noteworthy. Laos, Malaysia, Sri Lanka and Cambodia all possess relatively high levels of external debt (above 60% of Gross National Income, GNI, in 2017). Sri Lanka is also at risk because the country’s FX reserves do not match short-term debt. Moreover, while depreciation is one of the buffers that can be used to absorb external shocks, thus reducing the need to burn through FX reserves, it can also add to the pressures. The pass-through of higher import prices on inflation has weakened over time⁵, but uncontrolled episodes of depreciatory pressures have been shown to inflate external debt and create imported inflation⁶.

Neither synchronised recovery nor synchronised demise

Our index measuring relative vulnerability to outflows points to divergence in the exposure to external pressures amongst Asian EMs (see **Insert: Index Methodology**). The level of exposure varies

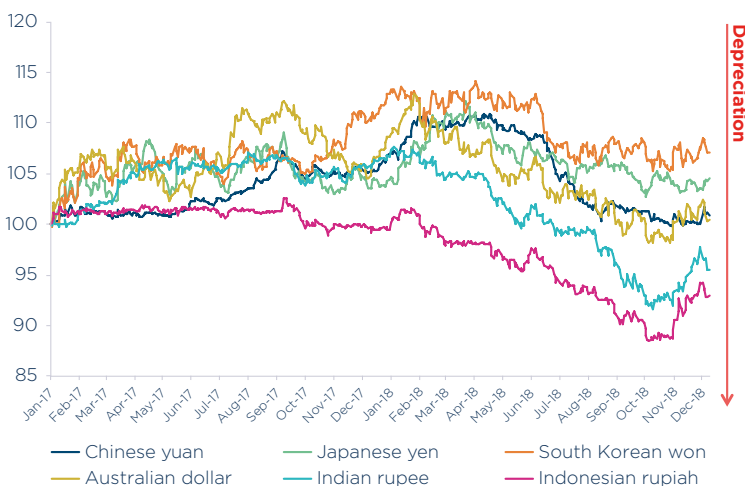
CHART 1:
Net portfolio flows* YTD YOY³ (including bonds and equities)



Source: Institute of International Finance, Coface

*including flows to India, Indonesia, Malaysia, Philippines, Taiwan, Thailand, Vietnam

CHART 2:
FX depreciation versus the US dollar YTD (base 100= Jan 2018)



Source: Bloomberg, Coface

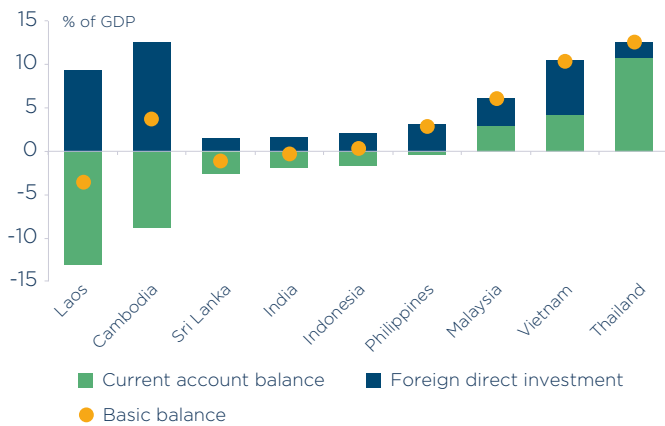
3 - Year-to-date, year-on-year

4 - Llorca M. (2017) External debt sustainability and vulnerabilities: Evidence from a panel of 24 Asian countries and prospective analysis. ADBI Working Paper Series, No. 692, Asian Development Bank Institute (ADBI), Tokyo.

5 - Garcia J.A. and Geraldine D.K. (2018) Monetary Policy and Inflation Dynamics in ASEAN Economies. IMF Working Paper 18/147, Washington D.C.

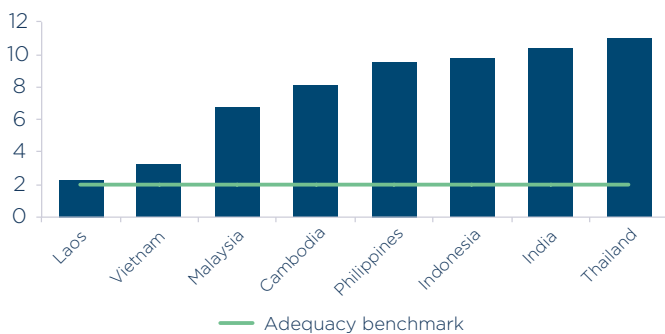
6 - Hawkins J. and Turner P. (2000) Managing foreign debt and liquidity risks in emerging economies: an overview. BIS Policy Papers, No. 8. Basel.

CHART 3:
Current account balance and FDI as a share of GDP in 2017



Sources: IMF, CEIC, Coface

CHART 4:
Months of imports covered by FX reserves



Source: World Bank, Coface

depending on existing vulnerabilities⁷, as well as the degree to which buffers are able to fend off those risks. For example, Turkey and Argentina, who both came under the radar at the beginning of the year, had unsustainable external positions and inadequate buffers to face external pressures. Asian EMs are not in the same situation today. While caution is warranted, markets may have gotten ahead of themselves in some cases (Chart 5).

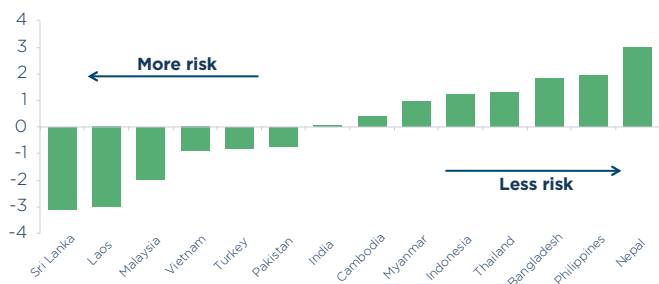
We have already started to see a rectification relative to October levels owing to strong fundamentals and proactive monetary policies. For example, the Indonesian economy is expected to continue to expand at a steady pace of 5.3% in 2018, and 5.4% in 2019. Moreover, Bank Indonesia has raised rates by 175 bps in the first nine months of 2018, faster than the Fed this year. This will help to maximise the risk premium and channel flows into Indonesian asset classes. India has also been proactive in building-up resilience: the Reserve Bank of India has hiked rates by 150 bps in 2018 and now has one of the highest interest rates in Asia. Moreover, domestic issues surrounding its financial sector notwithstanding, India remains amongst the fastest growing economies in the world, expected to expand by 7.3% in 2018 and 7.5 in 2019, ahead of China and the Philippines. Bangko Sentral ng Pilipinas (BSP) has hiked rates by 175 bps so far in 2018, but inflation

remains very high (6.0% YOY in November). Although real interest rate differentials with the United States remain large (Chart 6), which will drive outflows, financial buffers are more than adequate (FX reserves equivalent to eight months of imports, or 430% of short-term debt), reducing risks in the near future.

According to data from the IIF, the last time Asian EMs experienced similar net capital outflows, was after the election of US President Donald Trump. This is because portfolio flows are, to a large degree, also driven by risk sentiment. Markets have been grappling with risk-on modes once again, a consequence of escalating trade war threats between the US and China. This explains outflows from countries that have otherwise been doing well. The outcome of the trade war is difficult to predict, and despite the results coming out of the November G20 meeting, several disagreements between China and the US point to a continuation of protectionist risks into 2019. Moreover, higher oil prices in 2018 contributed to slower growth, as well as a worsening of the general mood towards Asia. Despite the recent correction in oil prices in October and November 2018, Coface expects that Brent prices will remain close to USD 75 per barrel on average in 2019 (i.e. stable versus 2018), as the Organisation of Petroleum Exporting Countries (OPEC) has agreed to cut output.

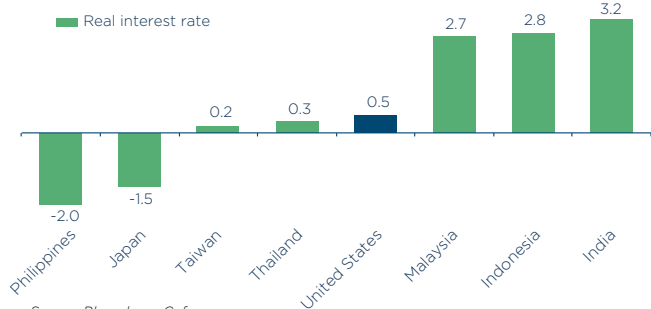
Capital outflows in 2019 will also remain conditioned by the pace of monetary policy tightening in the US, as well as inflation projections. Our baseline scenario implies a slowdown in the pace of Fed hikes (two hikes in 2019 compared to four in 2018), as inflation

CHART 5:
Coface Relative Vulnerability to Outflows Index results



Sources: Bloomberg, national sources, IMF, Coface

CHART 6:
Real interest rates remain negative for some



Source: Bloomberg, Coface

⁷ According to our model, most of the variance in the sample is explained by short term debt as a share of FX reserves, external debt stock to GNI and government debt.

has already slowed below the Fed's 2% target. In case of a downside surprise in the US, the existing differentials should warrant further tightening in the aforementioned cases. But this is a difficult balancing act, as tighter monetary policies may exert downside pressure on growth, reducing the attractiveness of these markets to investors.

Above all, the relative sustainability of the real external position remains the most significant consideration. The spotlight is on Pakistan at the moment, as the country is negotiating the terms of a bailout with the IMF. While the external debt stock to GNI is manageable (24%), government debt (67% of GDP) is high given that Pakistan's FX reserves stand below the adequacy benchmark. In the case of Sri-Lanka,

the country does not have enough FX reserves to cover its short-term debt (123%), which places the sustainability of its external position under threat, especially given its current account deficit and widening fiscal deficit (-6%). Malaysia has announced that it is renegotiating Chinese infrastructure projects in a bid to reduce its external debt. While this remains low in terms of Malaysia's relatively high GNI, FX reserves are not at adequate levels, which could lead to policy challenges in case of an exogenous shock – e.g. a downside revision to oil prices. Finally, countries that do not possess flexible exchange rate regimes may struggle to smooth currency fluctuations, as the reach of monetary policy is limited by the degree of dollarization of the economy; this is the case especially for Laos and Cambodia.

INSERT: Index Methodology

External vulnerability is determined by a myriad of factors. However, it can sometimes prove challenging to assess which of these factors weighs the most on vulnerability to outflows. For example, an economy may have accumulated significant debt, but FX reserves may be significant enough to offset these risks. For this reason, it is best to consider a wide array of possible sources of vulnerability, and use statistical techniques to synthesise the data into one singular outcome. The list of indicators that were used in this Index can be found in the table below:

Criteria	Source	"Zero risk" point of reference
1 Government debt (% GDP)	IMF ⁸	30%: higher debt = more risk
2 Budget balance (% GDP)	IMF	-3%: more negative balance = higher risk
3 Current account balance (% GDP)	IMF	0%: more negative balance = higher risk
4 Trade balance (% GDP)	IMF	0%: more negative balance = higher risk
5 Months of imports in FX reserves	IMF	3 months: less months = higher risk
6 Short term debt as a share of FX reserves	World Bank ⁹	30%: higher debt = more risk
7 External debt % Nominal GDP	CEIC	10%: higher debt = more risk
8 External debt stock to GNI	World Bank ¹⁰	30%: higher debt = more risk
9 Consumer Price Inflation (% YOY)	Bloomberg	3%: higher inflation = more risk

How to synthesize the data?

We used a simple Principal Component Analysis (PCA) to reduce dimensionality in the dataset. PCA is a statistical technique that reduces data from possibly correlated variables to a set of linearly uncorrelated variables, called principal components, or eigenvalues¹¹. The first principal component minimizes the distance between the data and the linearly uncorrelated variables, explaining most of the variation in the dataset. We use the first principal component in order to assess the relative risk levels of the countries in our sample. In order to do so, we first adjusted the directionality of the data to fit international adequacy benchmarks (the "zero risk" point of reference), before normalising the data and running the PCA¹². As would be expected, most of the variance in the first component is explained by short term debt as a share of FX reserves, external debt stock to GNI, and government debt. Factors such as the number of months of imports in FX reserves and the budget balance also played a relevant role. Structural aspects related to the current account balance and the trade balance play a more significant role in the second principal component.

⁸ - International Monetary Fund (IMF). *Assessing Reserve Adequacy (ARA) database*. Available at: <https://www.imf.org/external/datamapper/datasets/ARA> (Last accessed on 12/1/2018)

⁹ - World Bank IBDR *International Debt Statistics*. Available at: <https://data.worldbank.org/indicator> (Last accessed on 12/1/2018)

¹⁰ - Ibid

¹¹ - Jolliffe I. (2011) *Principal Component Analysis*. In: Lovric M. (eds) *International Encyclopedia of Statistical Science*. Springer, Berlin, Heidelberg

¹² - OECD (2008) *Handbook on Constructing Composite Indicators*. <https://composite-indicators.jrc.ec.europa.eu/>

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