Asia well placed to weather the storm

WITH THE FUNDAMENTALS IN EMERGING ASIA MARKETS – IN PARTICULAR THE BIG DEMAND-DRIVEN ECONOMIES – STILL STRONG, AND CENTRAL BANKS CALM BUT RESOLUTE, **PAUL GRUENWALD** IS OPTIMISTIC THAT THE REGION WILL STAVE OFF A DOWNTURN.

The bout of severe global financial turbulence that erupted in late July has once again raised questions about the resilience of emerging Asia. Has the region sufficiently delinked from the West? What are the possible financial contagion channels and the associated vulnerabilities? Are the policy-makers up to the task and do they have enough ammunition to combat a downturn? The bottom line is this: we retain our optimistic outlook, but note that the risks have shifted clearly to the downside.

Before presenting recent developments, the policy response and the outlook and risks, what are the contagion channels from the transatlantic turbulence to emerging Asia that we are watching? We see three:

■ **The global growth channel**. With slower growth now in store (and largely priced in) for the G20 economies, what are the risks to activity in emerging Asia? It ultimately comes down to a question of trade dependency and openness. The larger economies (mainland China, India, Indonesia) are mainly driven by domestic demand and should see the smallest impact. In contrast, the smaller, more open economies of Hong Kong, Malaysia, Singapore, Taiwan and Thailand should be more affected.

■ **The risk-off, balance of payments financing channel**. With markets in risk reduction mode, allocations to perceived risky assets (historically understood to include emerging markets) will decline. Economies relatively reliant on foreign savings – ie. those running current account deficits (India, the Philippines, Vietnam) – would be more at risk. Currencies of these economies should underperform as well.

■ **The bank funding channel**. Should a deterioration of events in Europe lead to stress in the wholesale funding markets (which happened during the global financial crisis post-Lehman), banks that rely on such funding – that is, those with a loan-to-deposit ratio in excess of 100% – could see restricted access to funds. This would mostly likely lead to a compression of the loan book and have a negative effect on activity in credit-intensive sectors.

THE SLOWDOWN LOOKS MANAGEABLE
Developments are playing out as expected so far. On the real side, growth across the region was easing before the recent volatility, but has begun to split along familiar lines. Q2 GDP numbers have now been reported for all economies in the region and we see a clear break between the larger economies, where growth has held steady, and the smaller, more open ones, where activity stalled or contracted (Figure 1).

The main culprit for the split has been net exports, which account for a larger contribution of GDP in the smaller economies. Encouragingly, domestic demand growth across most of the region, particularly consumption, appears to be holding up relatively well. Investment, given its links to exports, has been more mixed.

So far, higher frequency indicators into Q3 show a continuation of Q2's weakening trend, but we are looking for stabilisation. The most watched indicator is the purchasing managers' index (PMI), which gives us a timely (sentiment-based) read on production and, in the more open economies, exports. As Figure 2 shows, PMIs have been falling this year and in Korea, Singapore and Taiwan – all open, bellwether economies – are now below the 50 mark, signalling a contraction in manufacturing activity. PMIs in China and India remain above the 50 threshold.

Not surprisingly given the slowdown in global growth, trade has taken a big hit this year, driven by shipments to the US and EU, although trade with the rest of Asia has held up relatively well. Net exports, the relevant metric for GDP (which is a value-added concept), have correspondingly weakened.

The relatively moderate nature of the slowdown so far is also seen in inflation. While headline inflation appears to be peaking in some economies, core inflation continues to trend higher almost everywhere, suggesting that more needs to be done on the policy front provided that normal growth resumes in the near term. Our analysis still shows that emerging Asian economies are operating at or near full capacity, implying there is little pressure for prices to moderate from the demand side.

JUMPY MARKETS In contrast to the real economy, financial markets have been volatile. Net foreign equity flows have turned sharply negative since late July. These equity sales, which we interpret as being consistent with risk reduction, have taken place across bourses in emerging Asia, led by Taiwan, South Korea and India.

These equity sales have not translated into large sell-offs in the currency markets. While the value of the US dollar against the Asian currencies excluding Japan (USD-AxJ) has moved higher, it has not risen in line with the spike in net equity sales. Our interpretation is that investors are selling equities in line with the repricing of global growth, but are maintaining positions in local currencies with a view that Asian currencies will soon start appreciating again.

Market perceptions of emerging Asian sovereign risk remains positive and recent price action has been muted. In contrast to events in Europe, credit default swap (CDS) spreads on Asian sovereigns have risen only modestly since the onset of the latest round of turbulence. Most increases for the benchmark five-year contract have been under 0.25 percentage points. Vietnam, China and India have seen the largest jumps. Relatedly, our research shows that medium-term sovereign debt service profiles remain robust across the region.

BUT POLICY-MAKERS APPEAR CALM
Monetary policy-makers have reacted calmly to the recent bout of market turbulence. Unlike during the global financial crisis, benchmark rates have not been cut aggressively in response to lower growth prospects and/or to insure against large downside macro risks. Most policy-makers are signalling a pause in their tightening cycle to assess the impact of the turbulence, although officials in China and Thailand have continued to tighten monetary conditions through effective reserve requirement and rate hikes, respectively. Our reading of monetary policy statements is that a tightening bias remains since underlying inflation pressures are still elevated. But most central banks are comfortable pausing at present while continuing to monitor global developments with a view to gauging downside risks.

Exchange rates for emerging Asia have generally weakened since the onset of the turbulence, consistent with the "risk off" environment. However, as noted, the moves have been smaller than suggested by the record equity sales. Traders have also reported that central banks in the region have been selling reserves to keep their currencies stable (and not weaken) against the US dollar. One interesting exception is the Singapore dollar, which has seen increased demand and continues to face appreciation pressure, evidently reflecting its AAA ratings and safe haven demand. Not unlike its Swiss counterpart (before its recent move to put a hard ceiling on the currency's movements), Singapore's central bank has been acting to bring about low or even negative short-term rates in a move to discourage demand for the local currency.

Fiscal policy pronouncements have not figured prominently over the month or so since the turbulence erupted. In our view, most country authorities enjoy ample fiscal space and would be disposed to deploy additional resources to support growth should that become necessary.

Figure 1: GDP growth in emerging Asia

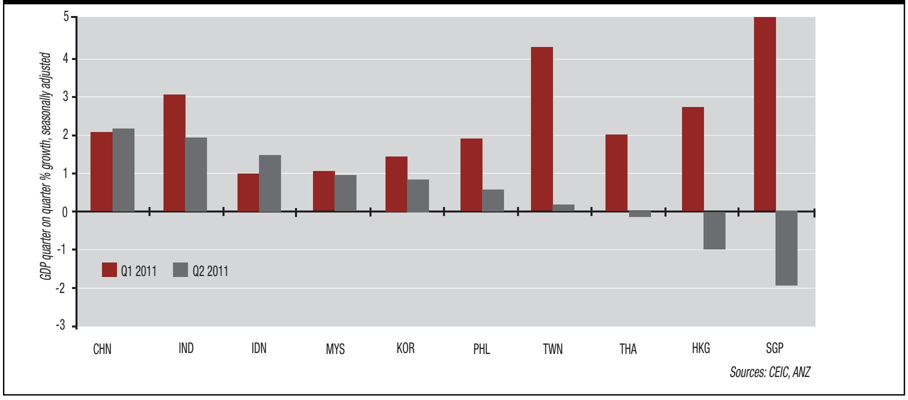


Figure 2: Manufacturing PMIs

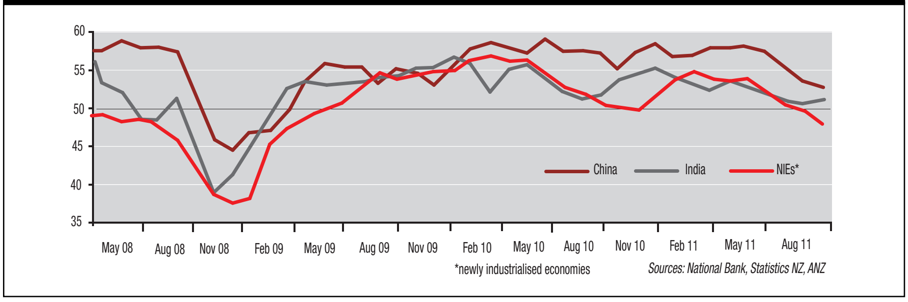
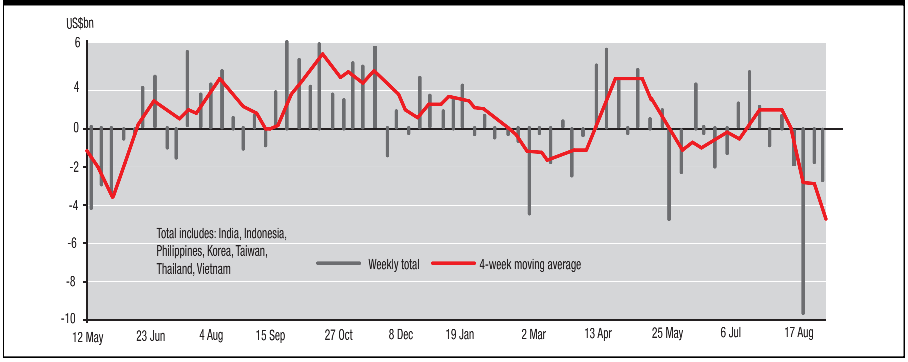


Figure 3: Net foregn equity flows, 2010 and 2011



CAN THE TAIL WAG THE DOG? We realise that our outlook for emerging Asia is relatively sanguine. What can go wrong? The main short-term risk is that the financial turbulence tail can wag the strong fundamentals dog. In other words, the longer the financial turbulence lasts, the higher the likelihood that Asia's strong fundamentals get overridden by financial fear. The likely result of that would be a steep drop in activity akin to what we witnessed during the depths of the global financial crisis.

Looking ahead, we would continue to emphasise our conviction that delinking from the West has strong implications for monetary and exchange rate policies in emerging Asia. The more independent that growth in emerging Asia becomes, the weaker the case for pegging an economy's exchange rate to the US dollar and, de facto, importing (inappropriately loose) US monetary policy. Continuing to do so will result in upside pressure on inflation and asset prices which, if left unattended, run the risk of creating serious repercussions down the road.

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