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Unorthodox measures

While many developed Western economies resorted to full blown monetary stimulus in the wake of the financial crisis, Asian countries have been more restrained in their policy response. Here, Douglas Reed, emerging markets strategist at Newton, asks whether 2016 could herald a change.

Radical monetary stimulus programmes have been an important feature of markets since the financial crisis. From Europe to the US, Japan to the UK, central banks have pumped trillions of dollars into the financial system in an attempt to revive ailing economies and repel the threat of deflation.

One region that has ploughed a different course, refusing to adopt similar measures to stimulate recovery, has been Asia. Despite its economies facing significant headwinds in the next 12 months, it seems unlikely to do so in 2016. "Quantitative easing is not really an option for most of the Asian countries, even if it were necessary," says Douglas Reed, emerging markets strategist at Newton. "Anything to do with excessive monetary policy would likely be interpreted badly by global capital markets. In any case, if the dollar remains strong, most of the Asian countries would not be able to do that much on the monetary side because they will have to consider the effect on their currencies."

Since the Asian crisis of 1997-98 governments in the region have curtailed their dollar borrowing and issued as a shamore debt in their own local bond markets. However, the flood of international money into the region in recent years has made these countries vulnerable to the vagaries of foreigners who are quick to move their money in times of turmoil. In 2015, Asian currencies were volatile and some weakened significantly, with commodity exporting countries being particularly hard hit: the Indonesian rupiah and the Malaysian ringgit fell to their lowest levels against the dollar in nearly two decades.[1]

The substantial international investment in some Asian government bond markets, notably Indonesia and Malaysia, makes them acutely sensitive to how investors perceive their financial health - hence the concern not to upset the capital markets. If the dollar's resurgence continues and Asian currencies weaken further the risk is investors could pull money from these markets pushing borrowing costs higher. This would at the very least preclude any interest rate cuts.

However, even Asian countries with better external balances and less commodity exposure will struggle to introduce monetary stimulus, largely because of their high levels of company and household debt, says Reed.

"Some countries like Thailand have low inflation and stable external balances but here the credit cycle is often already far advanced and there are concerns around how much debt they are carrying," he says.

As a share of personal disposable income, household debt in Singapore, South Korea, and Malaysia is higher than in the US before the financial crisis.[2] These countries are likely to be wary of introducing any measures that would encourage another debt surge.

Downside risks, or are they?

This gives Asian countries limited room to manoeuvre at a time when exports and economic growth are falling. The IMF expects 5.4% growth this year which it describes as "robust", though it adds that "growth is moderating and major downside risks are looming".[3]

These risks are the same as those that caused volatility in 2015. The fallout from rising US interest rates, a sharper slowdown in China and the decline in global trade continue to focus minds.

On the vexed issue of US rates, Reed thinks the impact on Asian markets and economies may not be as bad as everyone fears. "What seems clear to us is that the lack of upward domestic inflationary conditions in the US, together with the deflationary impact of a rising US dollar, means interest rates will increase only very slowly," he says.

He also remains in the positive camp on Chinese growth. "My expectation is the Chinese authorities will be able to stabilise growth to an extent. The economy will continue to slow, but at a slow rate." Unlike other Asian countries, which fear further currency weakness, Reed expects the renminbi to be allowed to depreciate by as much as 5% against the dollar in the coming year as the People's Bank of China gradually increases the market's role in determining the exchange rate.

Stimulating growth

While Asian countries have not been in a position to adopt the quantitative easing adopted in Japan, Europe and the US,governments in the region are not powerless. Given its still very healthy level of foreign exchange reserves, China's central bank arguably still has significant policy flexibility. Interest rates remain well above the zero bound while its high reserve requirement ratio (the proportion of a bank's assets that must be kept in the form of deposits at the central bank) can also be reduced

substantially if necessary, says Reed.

The bank has also developed a number of other monetary policy tools to boost domestic liquidity and credit availability. The Pledged Supplementary Lending scheme introduced last year has been used mainly to provide China's development banks with long-term, low-cost funding. That money can then be lent on to projects that the government wants to promote, particularly infrastructure schemes. Such indirect financing prevents the central government's debt burden from rising.

The recapitalisations earlier this year of the nation's two largest development banks, China Development Bank and Export-Import Bank of China, by the central bank using foreign exchange reserves, meanwhile, represent something different. "While this does not directly expand its balance sheet and so can't be categorized as QE, this is clearly more of a quasi-fiscal operation", says Reed.

The government has also taken action to rein in the burgeoning cost and unwieldy nature of local government borrowing. Beijing has been allowing local authorities to restructure their borrowing into municipal bonds and encouraging banks to buy the debt. This debt swap programme has been increased from an initial target of RMB 1 trillion for the year to RMB 2 trillion in June and then RMB 3.2 trillion.[4] Although this will improve banks' asset quality, the side effect will be lower earnings for commercial banks: they are after all being asked to swap their higher yielding loans for lower paying debt.

Some other Asian countries have also been adopting unconventional domestic stimulus measures which we could see more of in 2016. In Thailand, for example, the government has created a package to offer cheap loans to farmers and small and medium-sized enterprises.

Trans-Pacific Partnership

Looking further ahead, the nascent trade pact between the US, Japan and other Pacific Rim economies, the Trans-Pacific Partnership (TPP), has the potential to have a transformative impact on the region in years to come. However, it will take some time to be signed off. "It is very much a 2017 story," says Reed.

At the moment, Vietnam and Malaysia are the main countries in the region signed up to the TPP, but South Korea has been involved in negotiations and Reed believes China and other countries in the region will join in the future. However, they may have to overcome opposition internally from groups that could be disadvantaged by the crumbling of protectionist barriers.

"Generally countries will want to join because they will see the upside but there will be groups in countries that will be disadvantaged by the reduction in trade barriers. There may be concern about jobs being lost, for example. However, if implemented, I think countries will want to join so as not to get left behind."

What to watch

- Exports and economic growth in the region are forecast to keep falling: the IMF expects 5.4% growth this year
- Quantitative easing is not on the cards but look out for more monetary policy loosening by China
- More countries are expected to sign up to the Trans-Pacific Partnership

1. The Economist: *'Running out of puff'*, 3 October 2015
2. Deloitte University Press: *'Prudent no more'*, 1 July 2015
3. International Monetary Fund: *'Regional Economic Outlook Update Asia and Pacific Department'*, October 2015
4. CNBC: 'China expands debt-for-bond swap plan to 3.2 trillion yuan: Xinhua', 27 August 2015

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Douglas Reed, Newton
emerging markets strategist

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