FitchRatings

Sovereigns

Special Report

Emerging Asia Vulnerability to Global Quantitative Easing

Sovereign Ratings Reflect Risk Factors

Ratings[a]

	FC LT IDR	Outlook
China	A+	Stable
India	BBB−	Stable
Indonesia	BB+	Stable
Korea	A+	Stable
Malaysia	A−	Stable
Mongolia	B	Stable
Philippines	BB	Stable
Sri Lanka	B+	Positive
Taiwan	A+	Stable
Thailand	BBB	Stable
Vietnam	B+	Stable

[a] Foreign-Currency Long-Term Issuer Default Ratings (FC LT IDRs)

Analysts

Andrew Colquhoun
+852 2263 9938
andrew.colquhoun@fitchratings.com

Vincent Ho
+852 2263 9921
vincent.ho@fitchratings.com

Ai Ling Ngiam
+65 6796 7216
ailing.ngiam@fitchratings.com

Art Woo
+852 2263 9925
art.woo@fitchratings.com

Related Research

Applicable Criteria

- *Sovereign Rating Methodology* (August 2010)

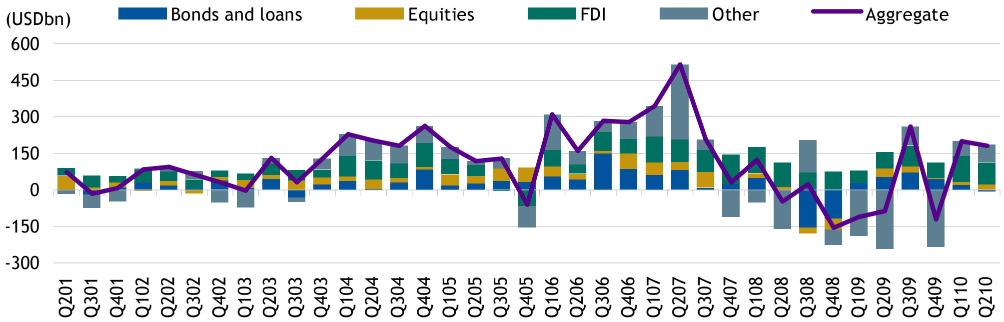
Other Research

- *Global Economic Outlook (October 2010)*
- *Macro-Prudential Risk Monitor (June 2010)*
- *Sovereign Review and Outlook (June 2010)*
- *China: Stimulus Hangover? (October 2010)*

Summary

Continued expansionary monetary policy in advanced economies poses a risk that strongly performing "Emerging Asia" countries will import inappropriately loose monetary conditions, in turn risking higher inflation and volatility in local asset markets. Some of the sovereigns plan to tighten controls on capital inflows — or already have — pointing to rising pressures on policy frameworks as US investment abroad recovers. Nine of 11 Emerging Asian sovereigns have some form of currency link to the USD.

Chart 1: US Flows to Rest of World



Source: CEIC

This report offers a snapshot of which of the Emerging Asia sovereigns are most exposed to the risks associated with global quantitative easing (QE).

Key Findings

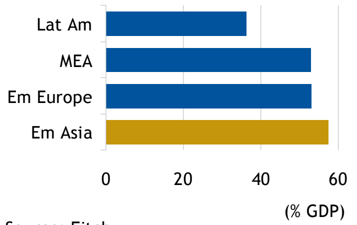
- Overall, the reasonably close correlation between the risk rankings and sovereign ratings suggests Fitch's sovereign credit analysis is paying due weight to the factors considered here, including robust economic policy frameworks and financial system strength.
- Taiwan emerges as the least vulnerable sovereign to further QE on this assessment, thanks to its low and stable inflation and well-developed financial markets.
- Indonesia and China are outliers relative to rating levels, at third and sixth most vulnerable respectively. Indonesia's weaker showing is driven by higher and more volatile inflation and by relatively shallow and volatile domestic financial markets, while China's already-strong real credit growth points to risks from a further loosening in global monetary conditions.
- Data for 2010 to date suggest the monetary policy dilemma posed by diverging domestic and external conditions may be growing more acute for Indonesia, Korea and Malaysia in particular.
- While excessively loose monetary conditions could weigh on Emerging Asian sovereign creditworthiness in the medium term, it is worth noting that the risks essentially reflect broader strengths in regional sovereign credit profiles including generally strong growth through the global financial crisis.

Table 1: Emerging Asia Currency Regimes

China	Crawling peg
India	Managed float
Indonesia	Managed float
Korea	Free float[a]
Malaysia	Managed float
Mongolia	Managed float
Philippines	Free float
Sri Lanka	Crawling peg
Taiwan	Managed float
Thailand	Managed float
Vietnam	Crawling peg

[a] Some evidence of enhanced currency management during 2010
Source: IMF, Fitch

Chart 2: Trade Openness
(Receipts and payments)



Source: Fitch

Starting Point: The "Impossible Trinity"

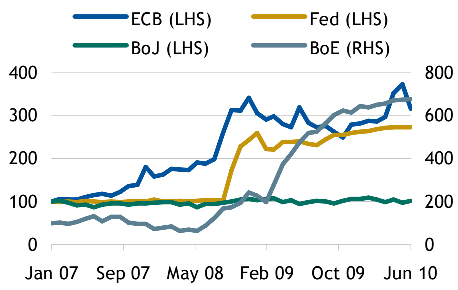
Many emerging markets, including emerging Asian economies which are the focus of this report, are exposed to US monetary conditions through more or less formal currency links to the USD. Of the 11 currencies in Fitch's Emerging Asia region, only Korea and Philippines are classified as having "free floats"; of those, Korea has recently been accused of keeping its currency artificially weak[1] (see Table 1).

The so-called "impossible trinity" argument from international macroeconomics points out the incompatibility of a fixed exchange rate, an open financial account, and monetary policy independence. With a fixed exchange rate and an open financial account, attempts to tighten monetary policy to ward off inflation for example would tend to attract capital inflows and either force up the exchange rate or ease domestic financial conditions, undoing the original tightening.

As Fitch highlighted in the October "*Global Economic Outlook*", monetary policymakers have been openly discussing their options for additional QE measures amid signs that the global economic recovery may be faltering. A speech by US Fed Chairman Ben Bernanke on 15 October was widely interpreted as signalling that additional QE would be on the agenda of the Fed's November policy-making committee. The Bank of Japan has already acted, directly intervening to lower the JPY in September and implementing further domestic QE in October. The widespread assumption that QE puts downward pressure on the home currency, boosting export competitiveness, has elevated the issue to the highest political levels and led to heated talk of "currency wars" around the G20 meetings in Korea.

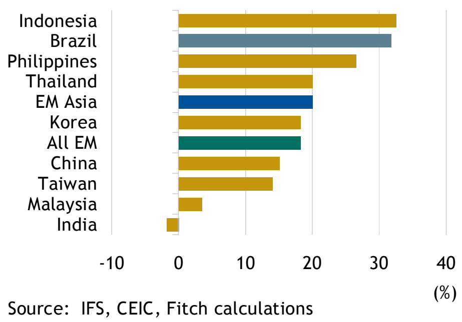
Charts 3 and 4 illustrate the degree of balance sheet expansion of central banks both in advanced economies and in emerging economies in terms of foreign-currency reserve acquisition. Overall, Emerging Asian economies saw reserves rise 20% in the year to July 2010. Emerging Asian economies were not alone in this: emerging economies as a whole experienced 18% growth in official reserves over this period, while Brazil's reserves rose 32%, testifying to the scale of inflows into that economy.

Chart 3: CB Balance Sheet Sizes
(Index, Jan 2007 = 100)



Source: CEIC, Fitch

Chart 4: EM Official Reserves
(YoY growth, July 2010)



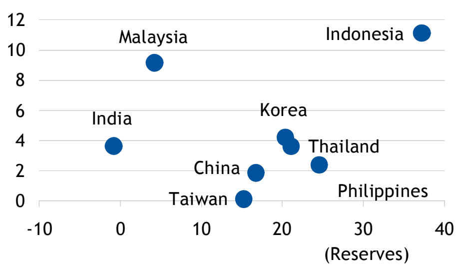
Source: IFS, CEIC, Fitch calculations

There is some evidence that countries experiencing stronger reserves growth have seen less currency appreciation, an issue explored in Charts 5 and 6. (Sri Lanka, Mongolia and Vietnam are excluded from these charts on account of their sharp growth rates of reserves in 2010 from very low levels in 2009, in Mongolia and Sri Lanka's cases under the aegis of IMF programmes.) The correlation is less clear when India and Indonesia are included in the analysis, reflecting the lesser importance of capital flows for India, which already has extensive capital controls, and in Indonesia's case the fact that the IDR has appreciated 11% despite 37% growth in official reserves.

[1] "Currency warning to S. Korea and China", Financial Times, 13 October

Chart 5: Reserves/Exchange Rates

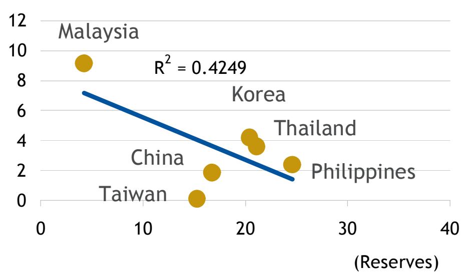
YoY growth to July 2010



Source: CEIC, Fitch calculations

Chart 6: Reserves/Exchange Rates

YoY growth to July 2010

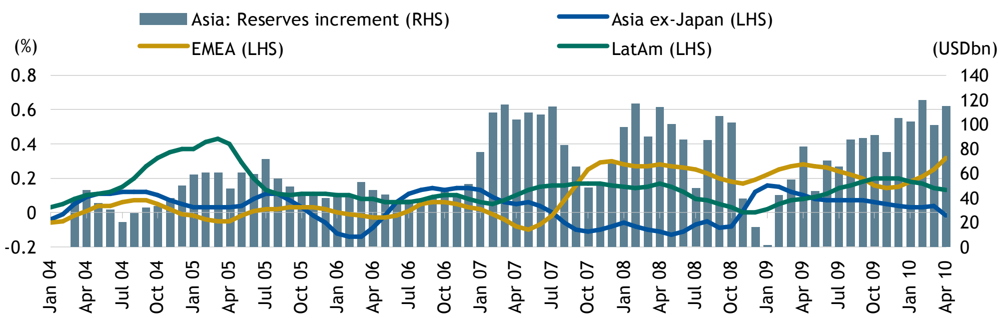


Source: CEIC, Fitch calculations

Analysis done by the IMF and summarised in Chart 7 indicates that Emerging Asian economies have done relatively well at sterilising the impact of reserves growth on their domestic financial systems. The correlation between changes in official reserves and domestic money growth, as assessed by the IMF, has generally been weakest in Emerging Asia.

However, sterilising FX inflows has costs — the narrow fiscal cost of issuing higher-interest liabilities to offset acquisition of lower-interest-bearing FX assets, and potentially broader costs of distorting normal financial market functioning. There is no guarantee that Emerging Asian sovereigns can continue to sterilise inflows so effectively, particularly if the scale of inflows were to increase materially.

Chart 7: Reserves/Money Growth Correlations



Source: IMF "Financial Stability Report" Oct 2010

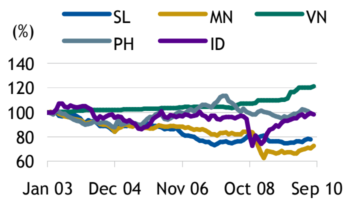
How to Assess Emerging Asian Vulnerability to QE

Emerging Asian economies could find themselves exposed to looser global monetary conditions through capital inflows as USD liquidity searches for yield. The framework developed below tries to assess which economies are better able to ride out the potential impact of heavier inflows by looking at which countries have better-entrenched monetary and financial stability.

More specifically, Fitch looks at the following factors in assessing sovereign credit exposure to risks associated with further QE.

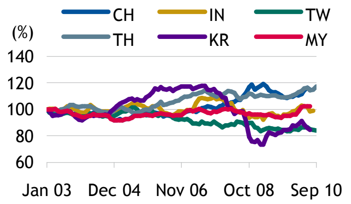
- Level and stability of inflation: Economies where price stability is less well-entrenched and price expectations are less well-anchored may be more exposed to the macroeconomic effects of a further loosening in global monetary conditions.
- Real interest rates: The current exercise assigns higher vulnerability to countries with lower or negative real interest rates for 2010 on the view that low real rates indicate the constraints on setting appropriate monetary policy for domestic conditions are already binding more tightly.

Chart 8: Exchange Rates
Nominal effective; Jan 2003 = 100



Source: CEIC

Chart 9: Exchange Rates
Nominal effective; Jan 2003 = 100



Source: CEIC

- Asset prices: Countries are ranked by the five-year volatility of real house prices and nominal stock market indices down to 2009, as a history of asset price volatility may signal greater potential for financial instability to arise if too-loose monetary conditions lead to renewed or more severe asset price bubbles.
- Development of domestic financial markets (measured by the stock of bank credit as a percentage of GDP at end-2009; Fitch's forecast real credit growth for 2010; average stock market capitalisation in the year to September 2010, also as a percentage of GDP; and dollarisation, i.e. the share of bank assets denominated in foreign currency, overwhelmingly USD in emerging Asia): Larger banking systems may be better able to absorb central-bank sterilisation of reserves growth. Countries already expected to experience more rapid credit growth in 2010 may be those most vulnerable to a further loosening of monetary conditions. Stronger financial market development and lower dollarisation are interpreted as signalling greater financial-system robustness.
- Exposure to global financial market conditions (measured by the end-2009 stock of non-bank private-sector external debt, as a percentage of GDP): the approach taken here is that a higher stock of corporate external debt signals greater exposure to international financial market conditions.

The treatment of the indicators selected for this analysis is narrowly focused on addressing the question of exposure to QE-related risks and may well differ from the usual approach in Fitch's sovereign rating methodology. In particular, a high stock of bank credit to GDP is here treated positively as an indicator of greater banking system capacity for absorbing central bank sterilisation of capital inflows. However, a broader sovereign credit analysis would have to take account of the contingent liability posed for sovereigns by the potential need to provide support for banking systems, which would increase with the size of the system.

Nominal exchange-rate volatility can be a useful indicator in assessing the robustness of a financial system, particularly for trade-driven economies and/or those with heavily dollarised financial systems. However, this indicator was left out of the current analysis owing to the concentration on the risks arising from fixing exchange rates, and to avoid a contradiction where countries with tighter exchange-rate management would have appeared less risky.

One way out of the "impossible trinity" is to impede capital inflows by tightening capital controls. Some movement in this direction is already occurring: in October, Thailand removed an exemption from a 15% withholding tax on foreign bond investors. Korea has signalled it is considering a similar move, although Fitch believes action is unlikely ahead of its hosting the G20 discussions in November. Outside the region, Brazil has doubled the tax on foreign investment in its government bonds.

However, India went the other way by lifting the ceilings on foreign investment in its government and corporate bond markets in September, while China has tentatively begun liberalising offshore issuance of RMB-denominated debt by domestic issuers.

Capital controls can be circumvented and can distort the pattern of investment in a country, while Fitch believes most regional policymakers retain an interest in fostering their countries' images as investor-friendly jurisdictions. The agency does not therefore expect stepped-up capital controls to play a leading role in redressing the risks discussed here.

Table 2: Risk Rankings

Country	Inflation: Inflation level	Inflation: Inflation volatility	Current policy: Real interest rates	Asset markets: Real estate	Asset markets: Equities	Financial market development: Inter-mediation	Financial market development: Real credit growth	Financial market development: Stock market cap	Dollar-isation	Non-bank ext. debt	Overall (average)	Rank
Vietnam (‘B+’)	1	1	3	4	2	8	3	1	2	11	3.6	1
Mongolia (‘B’)	3	2	11	1	1	4	4	2	1	10	3.9	2
Indonesia (‘BB+’)	2	4	9	6	4	1	2	4	5	6	4.3	3
Philippines (‘BB’)	5	6	7	3	7	3	7	7	4	4	5.3	4=
Sri Lanka (‘B+’)	6	3	8	7	5	2	8	3	3	8	5.3	4=
China (‘A+’)	9	5	10	5	3	11	1	5	9	9	6.7	6=
India (‘BBB–’)	4	8	1	11	6	5	5	9	11	7	6.7	6=
Thailand (‘BBB’)	10	7	2	9	9	6	11	6	10	1	7.1	8
Malaysia (‘A–’)	8	9	6	2	11	9	6	10	8	3	7.2	9
Korea (‘A+’)	7	11	4	10	10	7	9	8	7	2	7.5	10
Taiwan (‘A+’)	11	10	5	8	8	10	10	11	6	5	8.4	11

Countries ranked in order of vulnerability, with ‘1’ being most vulnerable
Source: Fitch

Vulnerability Rankings: Broadly in Line with Ratings

Table 2 sets out the vulnerability rankings for Emerging Asian sovereigns under the framework outlined above.

Vietnam emerges as the weakest economy in this analysis, at the weak end of the scale for all indicators except its level of financial intermediation (with an end-2009 bank credit/GDP ratio of 114%) and the stock of non-bank private external debt (just 2.4% of GDP). The high ratio of bank credit may, however, not be as reliable an indicator of ability to sterilise strong capital inflows in Vietnam’s case owing to high dollarisation. Moreover, Fitch sees balance-of-payments weakness as a more material source of risk for Vietnam’s sovereign ratings, stemming from the risk of leakage of private-sector savings against the backdrop of a policy of crawling devaluation of the VND.

The rankings broadly correlate with countries’ ordinal sovereign ratings, although there are two outliers, Indonesia and China. Indonesia’s ‘BB+’/Stable FC LT IDR is supported by an impressive fiscal consolidation, a factor not considered in this analysis, while vulnerabilities such as a history of high and volatile inflation and relatively shallow and underdeveloped financial markets carry more weight in this exercise. (Similarly, India and Malaysia perform relatively strongly in this ranking, which takes no account of their relative rating weakness of public finances.)

Table 3: Macro-Prudential Risk Scores

	BSI[a]	MPI[b]
China	D	3
India	C	2
Indonesia	D	2
Korea	C	2
Malaysia	C	1
Mongolia	n.a.	
Philippines	D	1
Sri Lanka	D	1
Taiwan	C	1
Thailand	C	1
Vietnam	E	3

[a] Bank System Indicator
[b] Macro-Prudential Indicator
Source: Fitch “*Macro-Prudential Risk Monitor*”, June 2010, p.10

Table 4: Rebased Risk Rankings

Country	Inflation: Level	Inflation: Volatility	Current policy: Real interest rates	Asset markets: Real estate	Asset markets: Equities	Financial market development: Inter-mediation	Financial market development: Real credit growth	Financial market development: Stock market cap	Dollar-isation	Non-bank ext. debt	Overall (average)	Rank
Mongolia (‘B’)	3	1	7	1	1	4	4	2	1	10	3.4	1
Indonesia (‘BB+’)	2	3	10	6	4	1	2	4	5	6	4.3	2
Vietnam (‘B+’)	1	11	4	4	2	8	3	1	2	11	4.7	3
Philippines (‘BB’)	5	10	8	3	7	3	7	7	4	4	5.8	4
Sri Lanka (‘B+’)	6	6	11	7	5	2	8	3	3	8	5.9	5
China (‘A+’)	9	4	9	5	3	11	1	5	9	9	6.5	6
Malaysia (‘A–’)	8	5	5	2	11	9	6	10	8	3	6.7	7
India (‘BBB–’)	4	9	1	11	6	5	5	9	11	7	6.8	8
Korea (‘A+’)	7	7	3	10	10	7	9	8	7	2	7	9
Thailand (‘BBB’)	10	8	2	9	9	6	11	6	10	1	7.2	10
Taiwan (‘A+’)	11	2	6	8	8	10	10	11	6	5	7.7	11

Countries ranked in order of vulnerability, with ‘1’ being most vulnerable
Source: Fitch

Table 5: Impact of Rebasing on Rankings

China	0
India	-2
Indonesia	1
Korea	1
Malaysia	2
Mongolia	1
Philippines	0
Sri Lanka	-1
Taiwan	0
Thailand	-2
Vietnam	-2

Negative number = improvement
Source: Fitch

China emerges in the middle of the ranking, with the pace of real credit growth and stock-market volatility in the weaker end of the comparison. China's high stock of bank credit (148% of GDP end-2009) is scored as a strength here, although the high level of leverage in China's economy may emerge as a weakness if systemic problems arose in the banking sector, as highlighted in previous research by Fitch's Sovereigns and Financial Institutions teams. (Summary rankings of overall financial system risk are presented in Table 3.)

The analysis of inflation factors in the table above is based on inflation volatility measured over the five years 2005-2009 and Fitch's forecast for real interest rates in 2010. To test the robustness of the results to more recent developments, the exercise was repeated using inflation volatility and real policy interest rates calculated over 2010 year to date (see Table 4).

The net impact on rankings is shown in Table 5. Malaysia, and to a lesser extent Indonesia, Korea and Mongolia, all perform more poorly on the rebased rankings, in Indonesia, Korea and Malaysia this primarily reflects greater inflation volatility over 2010. In all countries, inflation has picked up since the turn of the year, rising to 5.8% for Indonesia (September data), up from 2.8% at end-2009; 3.6% in Korea (September) from 2.8% at end-2009 and to 2.1% in Malaysia (August) from 1.1%. The rebased rankings signal that for Indonesia, Korea and Malaysia in particular, the dilemma between setting appropriate domestic monetary policy and heading off the pressures of further global monetary easing may be growing more acute.

Limitations and Potential Risk Mitigants

While offering a snapshot of the potential impact of further global monetary easing on Emerging Asian sovereign credit, important limitations in the framework mean the report and rankings should not be taken as a substitute for Fitch's individual credit analysis reports, which balance the factors considered here alongside a much wider range of indicators and assessments. It is fair to note a number of limitations to the current approach.

First, it considers only a small range of indicators and does not pay much attention to important potential mitigating factors such as the inherent credit quality of a country's banks (with higher-rated banking systems more likely to ride out turbulence successfully) or medium-term growth prospects.

Second, to the extent countries hold down their currencies in an environment where they would otherwise be strengthening, they will tend to accumulate official foreign-currency reserves. This will strengthen sovereign balance sheets which would usually be a positive factor for sovereign creditworthiness.

Third, while additional US monetary policy easing may have consequences for Emerging Asian monetary policy management and financial stability, no attempt has been made to balance these risks against the consequences of an alternative case of a "double-dip" lapse back into recession in the US. Such a scenario would also be likely to have a significant negative impact on the creditworthiness of some sovereigns in Emerging Asia.

Fourth, if QE boosts global commodity prices, sovereign credit could be affected through the budget in countries such as India and Malaysia, where subsidies on items such as fuel and food are an important component of government spending. Full consideration of this channel would have required extending the analysis to the public finances and unduly lengthened the report.

Despite these limitations, the reasonably close relationship between the rankings developed here and the order of regional sovereign ratings suggests there is only quite limited scope for the issues addressed in this report to have a sovereign rating impact, although Fitch will continue to monitor developments closely.