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By Carlos Casanova, Economist
and Pauline Weil, Junior Economist
for the Asia Pacific region
Based in Hong Kong

Tighter global liquidity and Asia: not all gloom and doom

Asia[1] 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 Unites 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 levels[2].

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

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