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Heightened fragility in Indonesia, Malaysia, and Thailand

A mixture of deepening economic weakness and lingering political uncertainty has made three previous Asian economic stalwarts falter

- Commodity headwinds, global trade stagnation, uncertainty around US monetary policy normalization, weakening domestic consumption momentum, poor international reserves cushion, and onerous external debt exposure for corporates have been posing headwinds to the economies of Indonesia, Malaysia, and Thailand for a while. Adding to these difficulties is the question about the maneuverability of the political leadership in these countries, each with its idiosyncratic constraints of governance. The final straw has been the recent move by the Chinese authorities to weaken the RMB, which in turn has added more volatility to the markets, further undermined expectations of external demand and export values, and set off one more round of depreciation pressure for the respective currencies.
- To be sure, these three economies are not alone in being characterized by heightened vulnerabilities. Hong Kong and Singapore have considerable exposure to the risk of rising rates, as well as the ongoing slowdown in China. South Korea is saddled with high household debt (just like Malaysia, Singapore, and Thailand), which is hampering a recovery in consumption. India has seen its reserves rise sharply and current account deficit decline, but its private sector external debt burden is still substantial. Both the Philippines and Taiwan could face renewed weakness in external demand if growth in China and the US disappoint. Also, there are many economies outside of EM Asia with worse vulnerabilities.
- For the time being, however, Indonesia, Malaysia, and Thailand are Asia's fragile three, in our view. How can vulnerabilities be lessened in the near term? Indonesia could navigate through the ongoing challenges if President Jokowi can manage to get a vigorous public sector-led infrastructure spending cycle going and consumption bottoms out. Malaysia could put markets at ease if the government could move past the 1MDB-related storm. Thai authorities could improve sentiments through infrastructure spending and by providing a clear roadmap for political transition. We think Indonesia perhaps has the best chance to make a come-back in this cohort, as the economy is unburdened by leverage and is characterized by relatively stronger institutions and a more stable political dynamic.

Indonesia, Malaysia, and Thailand's many headwinds

Improvement in economic policy-making is critical, but improved governance is equally important

Commodity headwinds, global trade stagnation, uncertainty around US monetary policy normalization, weakening domestic consumption momentum, poor international reserves cushion, and onerous external debt exposure for corporates have been posing headwinds to the economies of Indonesia, Malaysia, and Thailand for a while. Adding to these difficulties is the question about the maneuverability of the political leadership in these countries, each with its idiosyncratic constraints of governance. The final straw has been the recent move by the Chinese authorities to weaken the RMB, which in turn has added more volatility to the markets, further undermined expectations of external demand and export values, and set off one more round of depreciation pressure for the respective currencies.

Below we examine the key points of stress in these economies:

Growth

Weak exports and stagnant domestic demand have pushed all three economies to well below-trend growth. While Thailand's economy appears to be the weakest (we expect 2.5% growth this year), the pace with which Malaysia's consumption and investment growth rates are slowing means it may have substantial downside ahead. Both Malaysia and Thailand's households are heavily indebted (86% and 80% of GDP, respectively) and there are hardly any consumption boosting measures in the pipeline.

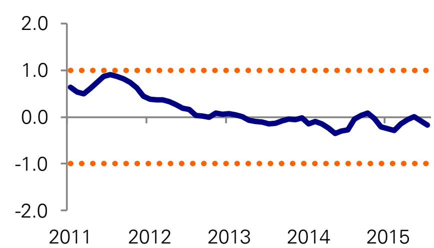
Export headwinds have been severe for Malaysia and Indonesia (-13.1%yoy and -12.8%yoy ytd) through the course of the year due to the sharp decline in commodity prices. Thailand has experienced somewhat less stress on the exports front (-5.2%yoy ytd), but it too has been facing weak agriculture and manufactured goods price and demand. Outlook for exports for all three economies is bleak for the rest of the year.

Public investment has disappointed in all three economies so far this year, although Indonesia looks on course to make up for lost ground as the government is ramping up public works and improve economic management through last week's cabinet reshuffle. Looking ahead for Malaysia and Thailand, considering the ongoing political challenges faced by the two governments, we are not hopeful about a meaningful pick-up in public investment this year.

External financing

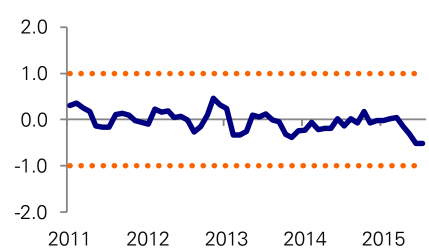
Just as growth is slowing, currencies are weakening, compounding the debt service difficulties of those with external currency obligations. Indeed, looking at the ratio of central bank reserves to gross external financing (defined as the sum of current account balance and debt due this year), Indonesia and Malaysia have the worst external metrics in Asia. Consider a typical commodity producer in Indonesia or Malaysia with external currency debt, facing a 50% decline in the price of exports and a 15% depreciation of the exchange rate. Clearly the pressure on profitability would be substantial and debt sustainability risk would rise. We understand that Indonesian exporters have been nudged into increasing their hedge ratios in recent years, which may mitigate their difficulties to some degree, but if the exchange rate continues to slide into uncharted territory, systemic stress is bound to emerge.

Growth momentum: Indonesia



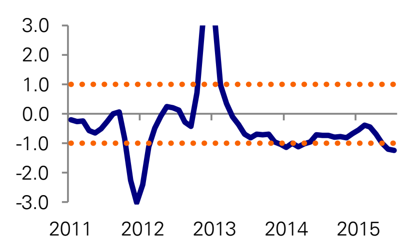
Source: CEIC, Deutsche Bank. Z score of high frequency growth related indicators

Growth momentum: Malaysia



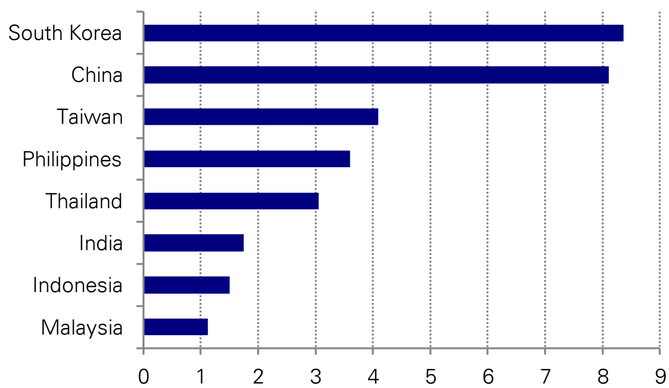
Source: CEIC, Deutsche Bank

Growth momentum: Thailand



Source: CEIC, Deutsche Bank

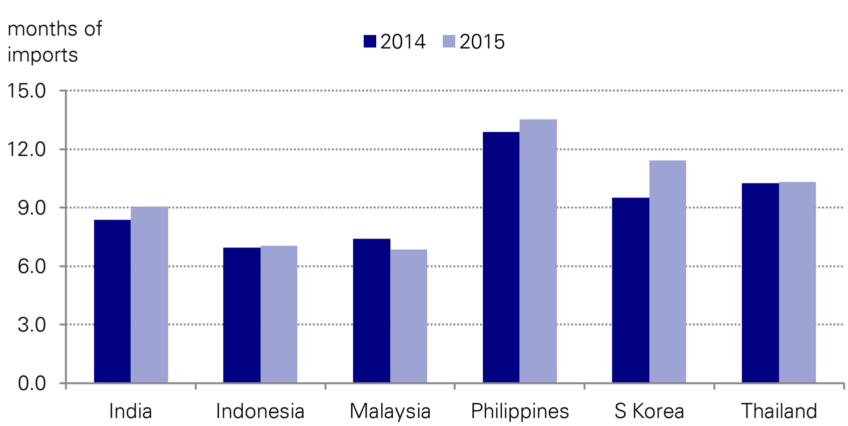
Reserves as a share of gross external financing needs in 2015



Source: BIS, CEIC, Deutsche Bank

The traditional metric of looking at an economy's reserves cover is gross international reserves in months of imports. What we do below however is apply a stricter criterion. Instead of gross reserves, we estimate usable reserves, i.e. excluding gold, SDR, IMF assets from the gross figure and netting out the central bank's forward position. Indonesia and Malaysia, using this metric, end up with around 7 months of imports. Malaysia in particular looks vulnerable to capital outflow as its reserves cover has been declining steadily. A study in contrast is India, which has improved its reserves cover considerably, rising markedly from the same level as Indonesia's just two years ago.

India's reserves position has improved, Indonesia and Malaysia are at the bottom of the pack



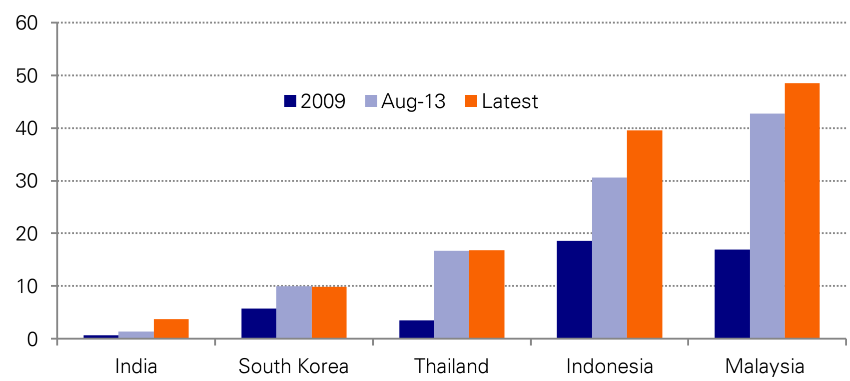
Source: CEIC, Deutsche Bank. Reserves coverage calculated by (i) taking the usable foreign currency reserves (i.e. excluding gold, SDR, IMF assets) and netting out the central bank's forward position and (ii) the merchandise import bill for a given year. 2015 imports are DB forecasts.

Outflow risk

Even if reserves are ample and external debt refinancing is not burdensome, large capital outflows through the portfolio channel can be destabilizing. In this context, the key is foreign investors' exposure to the local asset markets. Regional equity and bond markets have rallied vigorously in recent years, which would have given investors ample ground to take profit or play defensive in any case. Ongoing economic slowdown and currency stress makes that case even stronger.

The three economies in discussion (making up a local currency debt market amounting to USD300bn) have substantial exposure to foreign investors' positioning in local bond markets, and all have seen intensification of selloff lately. While it is unlikely for foreign ownership to head toward zero, further selloff (and associated pressure on the currency and reserves) is likely on the cards in the coming quarters.

Foreign ownership of local currency bonds (% of bonds outstanding)

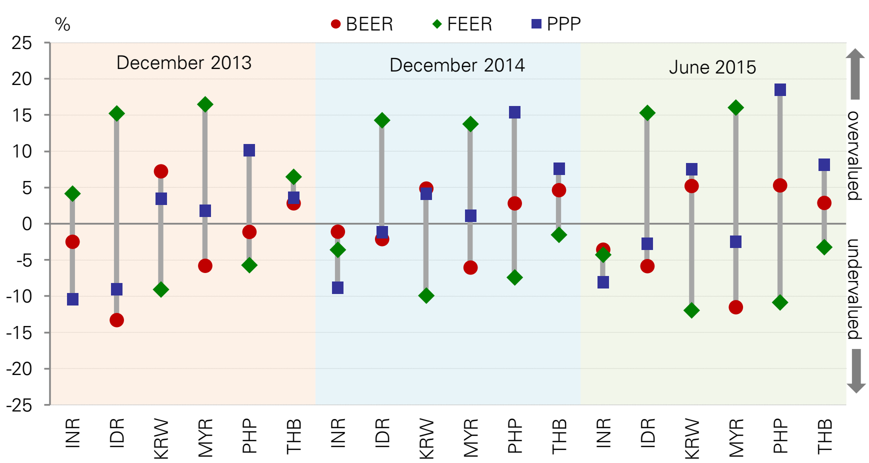


Source: CEIC, Deutsche Bank

Exchange rate valuation

We believe that IDR and MYR have overshot on a fundamentals basis, and ought to recover when the market mayhem ends. For the time being, however, prevailing stress in the global markets could persist for a while, and exchange rates could well stay in overshot territory. The worry is if local businesses in particular can absorb a prolonged period of acute currency weakness and volatility, as seen lately.

Our preferred BEER model shows the IDR and MYR have been undervalued since 2013, after the Taper Tantrum.



The chart above shows our estimates of exchange rate misalignment based on: (i) Behavioral Equilibrium Exchange Rates (BEERs); (ii) Fundamental Equilibrium Exchange Rates (FEERs); and productivity-adjusted relative Purchasing Power Parities (PPPs). The methodology behind these approaches is described in an appendix at the end of this note. While these approaches provide a useful measure of relative value of currencies based on longer-term fundamental drivers, they do not capture the wide range of factors that can drive currency movements in the shorter term, including technical positioning, levels of risk aversion, liquidity, and political and other events. As such, the fair value estimates presented here cannot and should not form the basis for short-term FX trading strategies, though they can provide one useful benchmark for the development of such trade recommendations.
Source: Haver Analystics and Deustche Bank.

Final thoughts

To be sure, these three economies are not alone in being characterized by heightened vulnerabilities. Hong Kong and Singapore have considerable exposure to the risk of rising rates, as well as the ongoing slowdown in China. South Korea is saddled with high household debt (just like Malaysia, Singapore, and Thailand), which is hampering a recovery in consumption. India has seen its reserves rise sharply and current account deficit decline, but its private sector external debt burden is still substantial. Both the Philippines and Taiwan could face renewed weakness in external demand if growth in China and the US disappoint. Also, there are many economies outside of EM Asia with worse vulnerabilities.

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Appendix 1

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