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The Daunting Challenges Emerging Markets Are Facing

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Recently, the exchange rates of Indonesian Rupiah and Malaysia Ringgit have fallen to 17-year lows against the US dollar, approaching the historical lows recorded during the Asian Financial Crisis in 1997-98. And Indian Rupee is also trading not far from its historical low recorded in 2013. Along with plunge in their stock markets, concerns are heightened that another financial crisis is brewing in emerging markets.

Emerging markets already in limbo

But before this year, cracks already appeared in emerging markets' armor. BRICS, as the world's five largest emerging markets located in Asia, Europe, South America and Africa, were already in crisis or succumbed to weakness. Hurt by oil price's plunge of 60% in 2014 and sanctions by the US and Europe, Russia had been in crisis mode since end 2014. During the first two quarters of this year, Russia's GDP was down by 2.3% and 4.6% from the same period a year ago. The IMF forecasts a 3.5% contraction for the Russian economy this year as a whole. Its inflation in July was 15.6%. And the Russian Ruble depreciated against the dollar by 46% in 2014, followed by another 14% this year to 70 Rubles per US dollar, not far from the record low of 79 Rubles at end 2014. As oil price revisited the $40 a barrel threshold recently, Russia's situation is nowhere near easing. Thankfully, its impacts are local, without triggering domino effects in emerging markets. Affected by similar plunge in commodities prices of about 40% in 2014 as measured by the CRB Index, Brazilian Real and South Africa Rand depreciated against the US dollar by 34% and 21% since 2014. For the first two quarters of this year, the Brazilian economy contracted by 1.6% and 1.6% respectively. With inflation as high as 9.6% and recurring current account and fiscal deficits, Brazil has been struggling even without unexpected external shocks.

In China's case, its economic fundamentals are among the strongest in BRICS. Its low inflation, current account surplus, low fiscal deficit, low external debt, high foreign exchange reserves, etc., are the envy of other emerging markets. However, slowing growth, plunging stock market, and the RMB's depreciation against the dollar constitute new uncertainties home and abroad. According to the IMF's latest forecast, India may register faster growth than China this year. Yet India is plagued by higher inflation (5.3% the latest) and twin deficits, with its fiscal deficit faring worse, rendering it more vulnerable to sizable capital outflows. Between end 2013 and beginning 2014, India and Indonesia were major concerns as the US rate hike loomed and subsequent fall feared. The pressure was off only after the US held rates unchanged later on. Nevertheless, the problem was only delayed, not solved. The Indian Rupee is trading at half of its pre Asian Financial Crisis level, and only about 4% from its historical low recorded in late 2013. A lot of bad news is being priced in.

The now and then of Asian emerging markets

The Asian emerging markets are all experiencing currency devaluation and stock market correction of late. But the similarities to Asian Financial Crisis stop at the surface. The Asian Financial Crisis was first a debt crisis. Borrowing large amounts of US dollar debt, substantial currency and maturity mismatch occurred when the dollar strengthened and capitals flew out, resulting in a debt crisis. It was then followed by a currency crisis. Under concentrated speculative attacks, Southeastern countries abandoned their fixed exchange rates to the US dollar one by one, resulting in plunge in exchange rates. Eventually, an economic crisis broke out. Unsustainable external debts in US dollars, sizable current account deficits, and rigid exchange rate mechanisms were to blame.

As of now, besides rebuilding sizable foreign exchange reserves, Asian emerging markets all command much better economic fundamentals than before. In terms of external debt, Malaysia is the only country with high external debt to GDP ratio (65%), which helps explain why the Malaysian Ringgit is weak. For others, the external debt ratios are between 22% and 38%. Combined with efforts to develop local currency bond markets, a debt crisis seems unlikely even under the same scenario of dollar strength and capital outflows. With the exceptions of India and Indonesia whose ten year sovereign yields at 7.8% and 8.9% respectively due to higher inflation, other Asian emerging markets' yields stand between 3% and 4%, with Thailand's benchmark sovereign yield as low as 2.8%. And their five year CDS spread stand between 100 and 200 basis points, less than Brazil and Russia's 345 and 421 basis points, suggesting little risk of a debt crisis.

In terms of current account, with the exceptions of India and Indonesia in mild deficits of 1.4% and 3.0% in 2014, other Asian emerging markets are all in surplus between 2.1% and 5.5% of their respective GDP according to the IMF's projections. Hence, they do not need to rely on inflows to finance their current account deficits, reducing the risks associated with strong dollar and capital outflows.

Another defense mechanism currently at work is the floating exchange rates. The mistake of defending fixed exchange rates until running out of foreign exchange reserves is not repeated by Asian emerging markets. Even though Indonesia, Malaysia and India's currencies are approaching their record low, it is driven mainly by market force, instead of uncontrolled collapse as the result of speculative attacks. In this case, the risk of triggering debt crisis and economic crisis is subdued. Prior to the outbreak of Asian Financial Crisis, the exchange rates of Thai Baht, Indonesian Rupiah, Malaysian Ringgit and Philipino Peso were all flat or at very narrow trading range against the US dollar, suggesting foreign exchange intervention to support the exchange rates. Later when Thai Baht gave up first because of the depletion of foreign exchange reserves, they succumbed to devaluation of more than 50% in few months, with Indonesian Rupiah devaluating by more than 80%.

But this time around, their exchange rates have been floating for 17 years. And since the US subprime crisis and financial tsunami, they have experienced both ups and downs, appreciating by more than 20% against the dollar in the first few years when the dollar was weak, and depreciating in the last two years when the dollar turned stronger. Although it does not mean their currencies will not make new lows or come under renewed speculative attacks, but floating exchange rates can help absorb a lot of shocks, and alleviate the risks of debt and economic crisis. Moreover, as China's manufacturing have been relocating to Southeastern Asia for years, weaker exchange rates can help increase the competitiveness of these countries' manufacturing and exports, as long as the depreciation is not forced or out of control.

Self-defense and collective defense

Amongst Asian emerging markets, it is impossible nowadays to identify anyone with worsening fundamentals across the board, unlike the pre Asian Financial Crisis era. The IMF projects that all the above mentioned Asian emerging markets will continue to grow for the next two years, with only Malaysia registering slower growth. In terms of growth rates, Thailand's 3.7% and 4.0% real GDP growth projections for 2015 and 2016 are the slowest, with the others estimated to grow between 4.8% and 6.8%. India's inflation and fiscal deficit are to the high side, but it is likely to grow the fastest amongst Asian emerging markets this year (7.5% to be exact). Its external debt is low, foreign exchange reserves high, enough to provide cushions. Indonesia is facing high inflation and twin deficits problems. But its twin deficits are mild. Decent economic growth should be able to help withstand pressure. Malaysia's external debt is high, and its fiscal deficit is also high. But it is boosted by current account surplus and low inflation. As long as growth is maintained, it still has some maneuver room. For Thailand, sizable current account surplus, mild fiscal deficit, and mild deflation can work to defuse political tension. Although the Thai Baht also depreciates against the US dollar, it is down by less than 5% so far this year. In fact, it is still up by more than a third from its record low level during the Asian Financial Crisis. The strong growth and current account surplus for the Philippines are believed to be enough to offset impacts from disinflation and mild fiscal deficit. Therefore, there is no evidence of a prelude to a new financial crisis from the currency devaluation by Asian emerging markets this year.

Learning from their painful lessons, not only do Asian emerging markets rein in external debt, float their exchange rates, they also amass sizable foreign exchange reserves over the past 17 years, especially between 2008/09 and 2010/11 when the dollar tanked. The foreign exchange reserves accumulation intensified during those years when Asian emerging markets tried to curb the strength in their currencies in order to maintain export competiveness. The latest foreign exchange reserves for India, Indonesia, Malaysia, Thailand and the Philippine are USD329.8bn, USD107.6bn, USD92.7bn, USD149.5bn, and USD80.3bn respectively, multiple times of the levels prior to the Asian Financial Crisis. Their war chests are deep indeed. Moreover, the IMF aid was the only help they could get 17 years ago. As of today, the IMF still stands ready to help. And the bilateral currency swaps implemented under the Chiang Mai Initiative involving ASEAN and China, Japan and Korea can provide collective defense against potential financial crisis. The currency swaps are yet to be put to use, but they will certainly help alleviate and even diffuse crisis should they be called upon in the worst case scenario.

The inevitable deleveraging

On the contrary, for Asian emerging markets, the painful adjustments are yet to come in full force. This means the much delayed deleveraging due to the strong dollar and capital repatriations back to the developed world. Developed economies resorted to zero interest rates and quantitative easing one by one after the US subprime crisis, financial tsunami and European sovereign debt crisis broke out. Part of the liquidity created flew into emerging markets, and interest rates in emerging markets were also suppressed, creating an extra incentive to borrow. This is obvious from the standpoint of the rapid foreign exchange reserves accumulation by emerging markets in order to rein in their own exchange rates. If emerging markets could not exert self-control by borrowing dollar debts excessively, they would be repeating the mistakes of the Asian Financial Crisis. Thankfully, only Malaysia's external debt seems to be to the high side so far.

Nevertheless, the odds are high that substantial corrections are in the cards even though the odds for crisis are low. The deleveraging in both the private and public sectors in the US and Europe has been ongoing for a while, and beginning to bear fruits. For their public sectors that are the last in line for deleveraging, fiscal deficits are close to returning to the safety zone, suggesting the most painful period of deleveraging is about to pass. The strength in their currencies relative to emerging markets currencies suggest capital repatriations that will help further alleviate the impacts from deleveraging. But on the other side, the deleveraging in Asian emerging markets may have just begun with their currencies devaluation.

McKinsey & Co. published a report titled Debt And (Not Much) Deleveraging in February this year, examining the debt and leverage of the world's major economies. The findings are that between 2007 and 2014, amongst the 47 economies that it tracks, only 6 recorded declines in their debt to GDP ratio ranging from government, nonfinancial corporates and households. They are all developing economies. And from their low base in 2007, developing economies accounted for half of the new debt during the 7 year period. But the development is not all negative because of the financial deepening of these development economies. Only when external borrowing increased the implication turns negative. Overall, the debt to GDP ratio for developing economies is half of the developed world, but there are concerns for individual ones. During those 7 years, the US, UK, Japan and Germany all experienced deleveraging in corporate and household sectors, while in emerging markets, especially Asian emerging markets, leveraging was the norm. Luckily, in their public sector, leveraging was mild and there were some cases of deleveraging. As a result, capital outflows will unlikely lead to sovereign debt issues. Rather, it is the domestic demands from corporates and households that will correct.

In McKinsey & Co.'s report, Singapore's nonfinancial debt to GDP ratio was 382%, the third highest in the world. But considering Singapore's financial center status, the ratio may be exaggerating. The next highest debt ratio in Asia was Korea's 231%, ranked 17th in the world. It was concentrating in corporate debt. But considering the robustness of the Korean economy, low government debt, and twin surplus, etc., it poses no threat. Malaysia and Thailand's debt to GDP ratios were 222% and 187% respectively, ranked 20th and 25th in the world. Malaysia recorded increasing debt burden in government, corporate and household levels, while Thailand's concentrating in household. For India, the Philippines and Indonesia, their debt ratios were not high to begin with. And during those 7 years, India saw a slight increase of its debt ratio by 5% to 120%, while the Philippines and Indonesia's debt ratios declining by 5% and 2% to 116% and 88% respectively. Accordingly, they face little deleveraging pressure.

Hong Kong was not listed in McKinsey & Co.'s report separately. Because of Hong Kong' status as one of the world's top three international financial centers, its corporate debt ratio may also be statistically high, which warrants no concerns. The HKSAR government has been running budget surplus for years, resulting in almost zero borrowing on their part. The government bond issuances during the past several years are purely for market development purpose. It is Hong Kong's household borrowing that is in the spotlight. According to HKMA's statistics, Hong Kong's household debt to GDP ratio reached a record high of 65.8% in the first quarter of this year, lower than Malaysia and Thailand's 76%, but higher than other Asian emerging markets. It was compatible with those of developed economies. For example, the household debt ratios for the US, UK, Japan and Germany were 77%, 86%, 65% and 54% respectively. In Hong Kong's case, the main component of household borrowing was mortgages at HKD1011.7 billion at 1Q15, equivalent to 45% of Hong Kong's nominal GDP of HKD2255.6 billion in 2014. With such a distinct feature, deleveraging pressure may not be so acute in case of capital outflows. This is because historically, mortgage lending has been Hong Kong banks' better asset class. During the Asian Financial Crisis, outstanding mortgage loans were never in decline. And during the financial tsunami of 2008-09, the slight decline was due to repayment outpacing new loans, instead of bad loans and large scale write-offs. And Hong Kong may even record safe heaven inflows due to its Currency Board System when Asian emerging markets record outflows. Hence, Hong Kong may be the last one to fall in the worst case scenario.

主要經濟指標 (Key Economic Indicators)

一. 本地生產總值 GDP	**2013**	**2014**	**2015/Q1**	**2015/Q2**
總量 (億元) GDP($100 Million)	20,961	21,446	5,736	5,662
升幅 (%) Change(%)	2.9	2.3	2.4	2.8
二. 對外貿易 External Trade	**2013**	**2014**	**2015/7**	**2015/1-7**
外貿總值 (億元) Total trade($100 Million)				
港產品出口 Domestic exports	544	553	41	282
轉口 Re-exports	35,053	36,175	3,167	20,113
總出口 Total exports	35,597	36,728	3,209	20,395
進口 Total imports	40,607	42,190	3,493	23,101
貿易差額 Trade balance	-5,010	-5,463	-284	-2,707
年增長率 (%) YOY Growth(%)				
港產品出口 Domestic exports	-7.6	1.7	-19	-14
轉口 Re-exports	3.8	3.2	-1.3	0
總出口 Total exports	3.6	3.2	-1.6	-0.2
進口 Imports	3.8	3.9	-5.2	-1.6
三. 消費物價 Consumer Price				
綜合消費物價升幅 (%) Change in Composite CPI(%)	4.3	4.4	2.5	3.5
四. 樓宇買賣 Sale & Purchase of Building Units				
合約宗數 (宗) No. of agreements	70,503	81,489	7,338	50,974
年升幅 (%) Change(%)	-29.9	15.6	-21.9	16.9
五. 勞動就業 Employment			**2015/4-2015/6**	**2015/5-2015/7**
失業人數 (萬人) Unemployed(ten thousands)	11.84	14.95	13	13.4
失業率 (%) Unemployment rate(%)	3.4	3.2	3.2	3.3
就業不足率 (%) Underemployment rate(%)	1.5	1.5	1.4	1.4
六. 零售市場 Retail Market			**2015/7**	**2015/1-7**
零售額升幅 (%) Change in value of total sales(%)	11.0	-0.2	-2.8	-1.8
零售量升幅 (%) Change in volume of total sales(%)	10.6	0.6	1.9	1.7
七. 訪港遊客 Visitors				
總人數 (萬人次) arrivals (ten thousands)	5,430	6,077	492	3,425
年升幅 (%) Change(%)	11.7	11.9	-8.4	1.0
八. 金融市場 Financial Market			**2015/6**	**2015/7**
港幣匯價 (US$100=HK$) H.K. Dollar Exchange Rate (US$100 = HK$)	775.4	775.6	775.2	775.2
貨幣供應量升幅 (%) change in Money Supply(%)				
M1	9.7	13.0	17.7	11.2
M2	12.3	9.5	7.9	5.1
M3	12.4	9.6	7.9	5.0
存款升幅 (%) Change in deposits(%)				
總存款 Total deposits	10.6	9.7	9.8	7.0
港元存款 In HK$	5.1	9.3	13.3	9.8
外幣存款 In foreign currency	16.2	10.1	6.4	4.3
放款升幅 (%) in loans & advances(%)				
總放款 Total loans & advances	16.0	12.7	8.5	6.9
當地放款 use in HK	13.8	12.1	5.4	3.2
海外放款 use outside HK	21.4	14.2	16.3	15.9
貿易有關放款 Trade financing	43.8	-1.4	9.8	-16.6
最優惠貸款利率 (%) Best lending rate (%)	5.0000	5.0000	5.0000	5.0000
恆生指數 Hang Seng index	23,306	23,605	26,250	24,636