Asian Insights: Reflexivity in the Fragile Five

Economic Research Note

30 September 2014

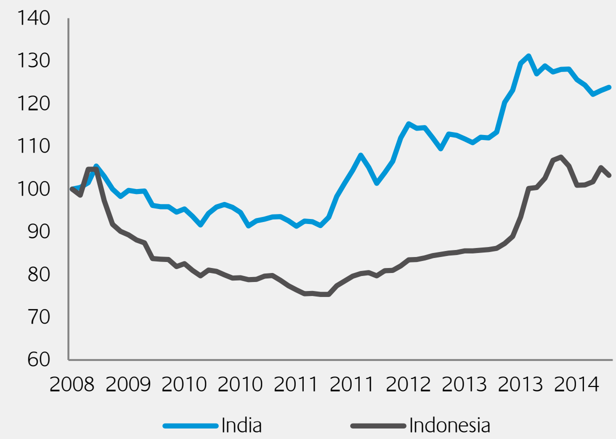
- Markets not only reflect economic outcomes but also create economic outcomes.
- Both India and Indonesia suffered in 2013, as strong inward flows of foreign capital turned into strong outward flows, as the Federal Reserve signalled a desire to slow the asset purchase program.
- But as markets improve, these economies should enjoy something of a tailwind, if they allow it.

Reflexivity is the often circular relationship between cause and effect. It's a concept used by George Soros and applied to markets and economies. Activity in financial markets will reflect a reaction to economic outcomes but also, at particular times, cause economic outcomes. The 2013 turmoil in the *Fragile Five* (Turkey, India, Brazil, Indonesia and South Africa) provide both negative and now, hopefully, positive case studies. This article focuses on the Asian members: India and Indonesia.

Markets and economies

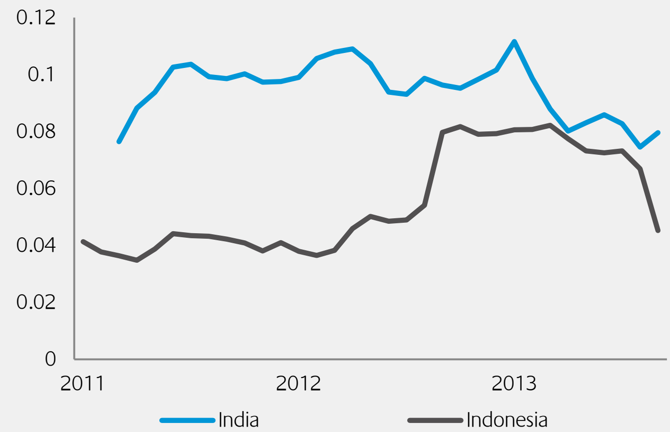
The US Federal Reserve's (the Fed) policy shift to signal the beginning of the Quantitative Easing taper had considerable spill-over consequences for financial markets and, in turn, economies. Amongst the more important consequences were the decline in currencies, rise in interest rates and subsequent economic malaise in emerging markets.

Chart 1: Indian & Indonesian exchange rates from Jan 09
index points, monthly, ending Aug 14



Source: CEIC and First State Investments.

Chart 2: Inflation in Indonesia and India
yoy change, quarterly, ending Jun 14



Source: CEIC and First State Investments.

Between 2007 and the end of 2012, emerging markets economies, globally, had seen US$1.17 trillion in gross external capital flows in both debt and equity. From 2009 to the second quarter of 2014, emerging markets corporations more than doubled their outstanding international debt to US$1.32 trillion[1]. Unconventional monetary policy in the developed world was the driving force of this capital flow. In Indonesia, for instance, such was the flow that at the end of 2011, Indonesian 10-year interest rates were lower than Italy's.

These capital flows posed something of a tri-lemma for Asian central banks; you can control one thing (short rates), maybe another (the exchange rate) but you can't control the other (capital flows). Each of these three is interchangeable. With an eye to supporting export industries, emerging markets became wary of anything that led to stronger currency appreciation.

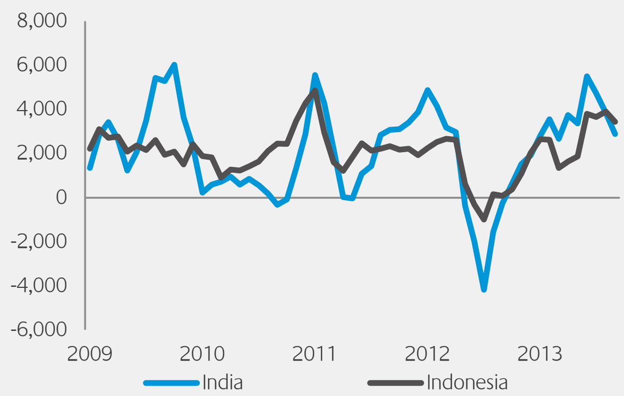
But with lower rates and strong credit growth, inflation persisted, particularly in India. In 2011, and despite acceleration in monetary policy tightening, it became obvious the Reserve Bank of India had fallen behind the policy curve. Indonesia too, failed to respond to

[1] Mohanty, M. S. The Transmission of unconventional monetary policy to the emerging markets, Bank for International Settlements, August 2014

increasing inflation. This failure to address domestic policy issues was crucial to understanding the impact of the Fed's hint in May 2013 that it was re-considering the scale of its asset purchase plan.

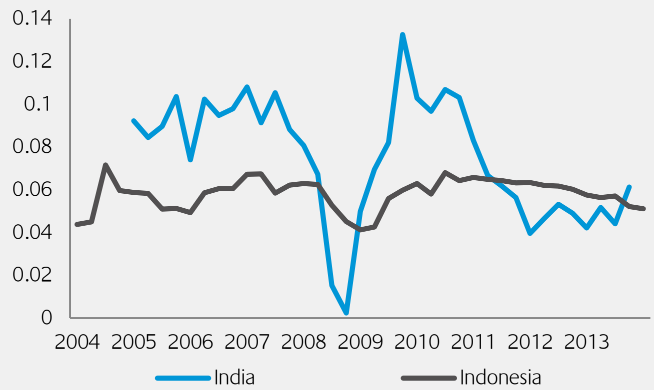
The Fed's hint meant policy-makers lost control of capital flows. In the three months from May 2013 US$12bn left India, while for Indonesia it was US$3.5 billion. In the 12 months, India received US$37 billion and Indonesia US$27.5 billion. The consequences were depreciating currencies (26% for the Indonesian rupiah and 27% for the Indian rupee), rising interest rates (the Indonesian 10-year rose from 5.5% to just over 9% and the Indian 10-year rose from 7.2% to 9.2%) and higher inflation. This is *reflexivity*.

Chart 3: Indian and Indonesia foreign capital flows
US$, monthly, ending Sep 14



Source: CEIC and First State Investments.

Chart 4: Indian and Indonesia GDP growth
yoy change, quarterly, ending Mar 14

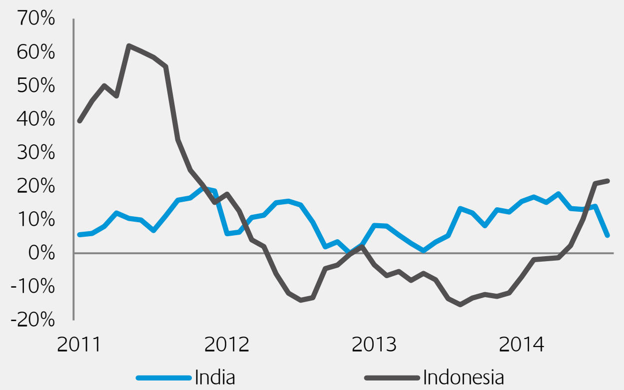


Source: CEIC and First State Investments.

The rise in inflation is most obvious in Indonesia. From its gradual path in 2012 and early 2013, Indonesian Consumer Price Index (CPI) rose rapidly in the months after the *taper tantrum* to 8% from 5% earlier in the year. In India, with a more persistent problem, the impact of a steep depreciation in the currency is less obvious. But expectations of falling inflation, evident in falling policy interest rates, were dashed, and instead a new cyclical peak of 11.2% reached in November 2013.

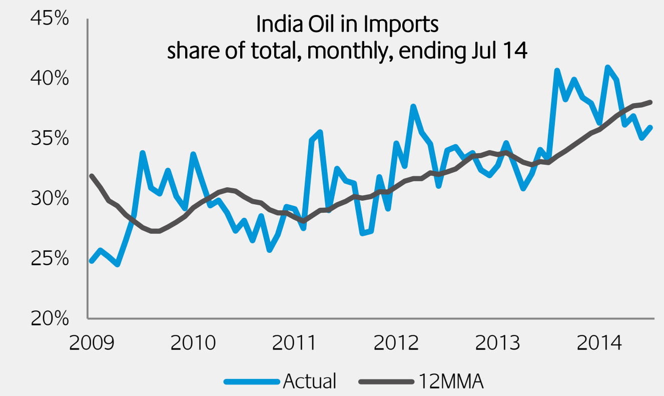
The consequence of inflation and subsequent monetary tightening was slower economic growth. In India, GDP growth hit 4.4% in December 2013 driven by growth in household consumption of just 2.8%. The growth hit to Indonesia has been less severe; GDP growth has fallen from over 6% to 5% since early 2013. Growth has been supported by a strong performance from net exports while household consumption and investment are lower.

Chart 5: Indian and Indonesia capital flows
yoy change, monthly, ending Sep 14



Source: CEIC and First State Investments.

Chart 6: Indian and Indonesia GDP growth
yoy change, quarterly, ending Mar 14



Source: CEIC and First State Investments.

Just as markets take away …

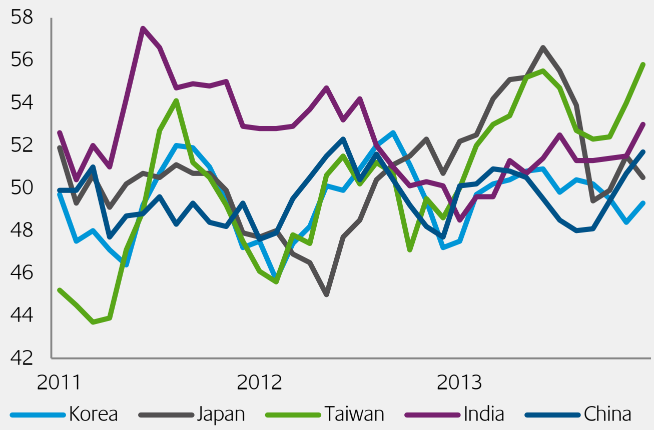
Just as markets can take away, they can give back. Investors can't afford to remain negative on a market, particularly if there is improvement and the cost of not investing is high (for both India and Indonesia this would mean missing out on 10-year yields of 9% in January). This gradual improvement in markets should flow forward to lower inflation (the exchange rate) and improved financing conditions (capital flows and lower interest rates). Furthermore, both countries have taken steps to improve their foreign reserves.

Intriguingly, however, both central banks have been reticent to allow markets to help out. India has stated that it doesn't want an appreciation that goes further than Rs 55 to the US$ (24% greater than the long-term average) while Indonesia, too, seems comfortable at current levels (38% higher than the long-term average). This has meant inflation remains uncomfortably high and there's been no substantial improvement in interest rates.

This strategy is based on the view that a weaker currency can aid the external balance. But it's not clear such a strategy will work in the current global economic environment. As the last *Asian Insights* highlighted, global trade is weak with only scarce signs of improvement. Furthermore, India, specifically, is a big oil importer and would benefit from a stronger currency in this regard. Oil imports are now more than 35% of all India's imports and much higher than when this started. It might be more sensible if these central banks let markets help them, rather than engineer more difficult outcomes.

Chart 7: Asian PMIs
index points, monthly, ending Sep 14

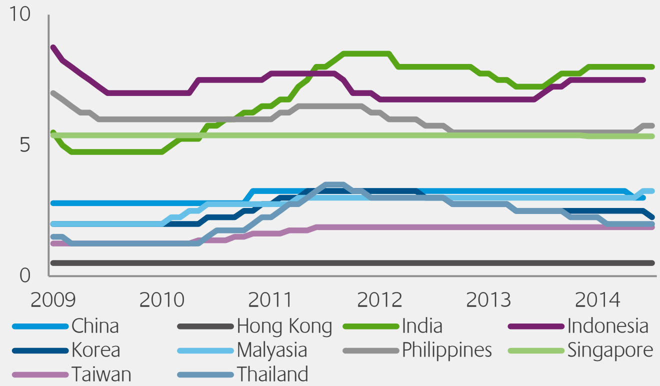
HSBC Purchasing Managers Index (PMIs) across the Asian region seem to be improving. The strongest improvement is in Taiwan and China. This may be a function of the launch of the Apple iPhone 6 which some economists estimate will add around one percentage point to Chinese export growth in 2014. The Japanese PMI data is a little more disappointing. The rise in the sales tax in April 2014 led, first, to a spike in the first quarter, and then a drop. The recovery from this drop has been less robust than policy-makers might have hoped. Even so, the combination of Apple's launch (a threat to other handset makers) and Japan's more competitive currency means the weakest performer in Asia for the moment is Korea.



Source: CEIC and First State Investments.

Chart 8: Asian interest rates
percentage points, monthly, ending Sep 14

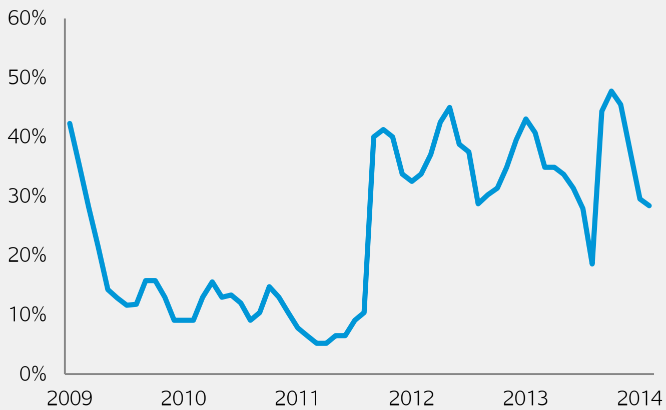
There's been a little movement in policy interest rates across Asia in the last month. The Philippines has begun a tightening cycle while Malaysia has re-commenced a tightening cycle that began in 2010. In both economies, inflation has risen sharply through the last 12 months. Of particularly concern would be the trend in the Philippines where inflation has risen from 2.1% to 4.9% in the space of 12 months. By contrast, the Bank of Korea has been able to resume its easing cycle. This is a combination of weak economic growth, as highlighted above, and the consequences of a strong currency, particularly relative to its keenest competitor, Japan.



Source: CEIC and First State Investments.

Chart 9: China Loss Making Large Steel Firms
share of total firms, monthly, ending Jun 14

One of China's most maligned industries is the steel industry. It suffers from over-capacity and is broadly seen as unsustainable. It is one of the most indebted Chinese industries; around 20% of China's corporate debt is held by steel firms. Interestingly, this debt has migrated from the long-term (about 45% in 2009) to the short-term (around 25% today). This reflects financing difficulties for many firms and the increased reliance on inventory as collateral rather than longer term assets. As the chart on the right shows, however, things are bad, but a little less bad. The proportion of loss making steel firms is falling (the number of firms in the survey is stable), suggesting firms are coping with lower prices and probably enjoying the fall in the price of iron ore.



Source: CEIC and First State Investments.

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