Monthly Update of the ASEAN+3 Regional Economic Outlook (AREO)

Feature: U.S. Tax Reform and Implications on Regional Emerging Markets

ASEAN+3 Macroeconomic Research Office (AMRO)

Singapore

February 2018

This Monthly Update of the AREO was prepared by the Regional Surveillance team and approved by Dr Khor Hoe Ee (Chief Economist).

The analysis in this report is based on information available up to 7 February 2018. For the sake of brevity, "Hong Kong, China" will be referred to as "Hong Kong" in the text and figures.

Global Growth Amidst Market Volatility

Early February saw more positive news of robust growth in the U.S. economy. While growth in the U.S. economy slowed to 2.6 percent in Q4 2017, this was due to stronger consumer spending leading to higher import growth that outstripped export growth. The Eurozone economy grew by 2.3 percent in Q4 2017 driven by corporate investment while the U.K. economic growth was estimated to pick up to 2.0 percent (Chart 1).

Labor market developments in the U.S. economy suggest robust growth (Chart 2).

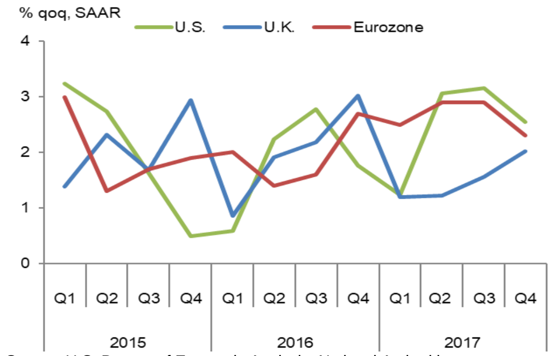
- The U.S. economy added 200,000 jobs, much faster than the market expected (consensus forecast: +180,000 jobs). The unemployment rate remains unchanged however, at 4.1 percent.
- Average hourly nonfarm wages grew by the strongest since 2009 (+2.9 percent).

Positive news on the U.S. economy however triggered underlying investor fears of reflation and an acceleration in U.S. monetary policy normalisation, leading to a sharp but short-lived market correction on 5-8 February 2018.

After peaking towards end-January 2018, global equity markets suffered its worst single day slump on 5-6 February 2018. It was the largest intra-day decline since August 2015, triggered mainly by the selloff in U.S. markets, with the S&P500 and Dow Jones Industrial Average (DJIA) plunging over 4 percent. Advanced market equities were the hardest hit. Emerging markets, including in the ASEAN+3 region, while not spared, were relatively resilient (Tables 1 and 2).

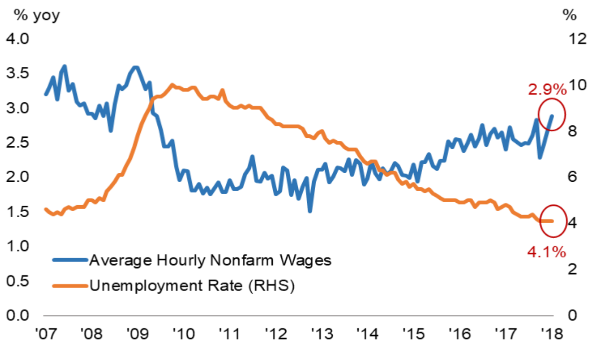
- Market jitters reflect concerns about U.S. inflation, and expected inflation in the U.S. has also spiked up recently (Chart 3).
- Recent comments from policymakers, notably the outgoing Fed Chair Yellen[1],

Chart 1 Robust Growth in the U.S. and EU



Source: U.S. Bureau of Economic Analysis, National Authorities

Chart 2 U.S. Labor Market Developments



Source: Reuters

Table 1 U.S. Stock Market Performance (5 Feb 2018)

Indices	Change	% Change
	(From Previous Close on 2 Feb)	
S&P500	-113.2	-4.1
DJIA	-1,175.2	-4.6
NASDAQ	-264.4	-3.9

Source: Reuters

Table 2. Global Stock Market Performance (A Comparison), (5 Feb 2018)

Indices	Change (Points)	% Change
	(From Previous Close on 2 Feb)	
	U.S.	
S&P500	-113.2	-4.1
DJIA	-1,175.2	-4.6
	Europe	
EuroStoxx	-6.1	-1.6
FTSE100	-108.5	-1.5
	Japan	
Nikkei 225	-592.4	-2.5
	Emerging Markets	
Asia Ex-Japan	-9.5	-1.6
Latin America	-70.0	-2.2
Emerging Europe	-36.2	-1.7

Source: Reuters

Note: Figures are as of 6th February 2018 for Europe, Japan and Emerging Markets.

[1] In her interview with CBS on 4 February 2018, Yellen mentioned that the price-earnings ratios for U.S equities were near the high end of their historical ranges

warning about the relatively high asset price valuations also contributed to market concerns.

Although there are reflation fears in the market, so far, inflation remains benign in the developed economies, as the U.S. Fed and the ECB have held interest rates.

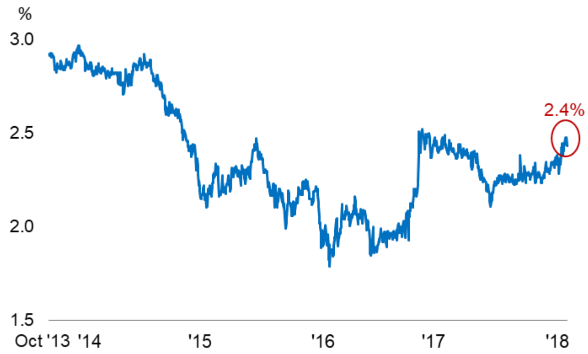
Spillovers to Regional Markets

The short-term impact on regional markets are mainly in equities, bonds and the currencies markets, which rebounded quickly.

- In **regional equity markets**, the impact was not as large (below 4 percent) at the close of trading on 5 and 6 February 2018. Most regional bourses (notably Vietnam, Philippines, Malaysia and Indonesia) rebounded the next day on 7 February (Chart 4).
- In **regional bond markets**, in tandem with rising U.S. Treasury yields (Chart 5), borrowing costs (10Y sovereign yields) in the regional emerging markets (EMs) have generally edged higher. While yields are noticeably higher at the start of 2018 in Korea and Philippines, they are not excessive given recent events. In contrast, in Thailand, Malaysia and Indonesia, yields are only higher by several basis points since January 2018.
- In terms of **capital flows**, after a largely sustained period of capital inflows, regional equity markets (Korea and ASEAN-5) saw some net outflows since 30 January 2018 (Chart 6). This is in line with earlier corrections in U.S. equity markets (which was prior to the sharp selloff on 5-6 February 2018). Regional EMs continue to benefit from net capital inflows into the bond markets, while regional EM currencies have been relatively stable.

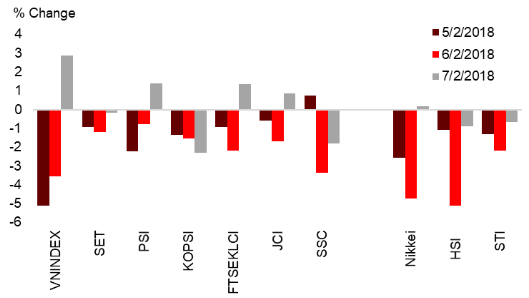
These themes of reflation triggering faster-than-expected monetary policy normalisation in advanced economies can be expected to recur throughout the year.

Chart 3 U.S. Expected Inflation (5Y/5Y Breakeven Inflation Rate)



Source: Reuters

Chart 4 Selected Regional EM Equities

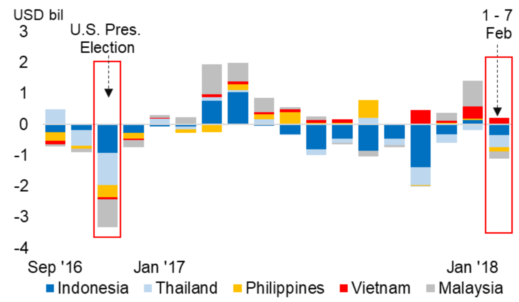


Source: Bloomberg

Chart 5 10Y U.S. Treasury Yields

Source: Reuters

Chart 6 Non-Resident Equity Capital Flows in ASEAN-5 Economies



Source: Bloomberg

Regional policymakers can therefore expect such episodes of market volatility after a prolonged period of market calm, as global financial conditions tighten, and should be careful not to overreact to short-term market gyrations.

Another source of market concern is the path of U.S. fiscal deficit following U.S. tax reforms, and its impact on U.S. Treasury yields and on emerging markets. This is explored in the **Feature on "U.S. Tax Reform and Implications on Regional Emerging Markets"** at the end of this Monthly Update.

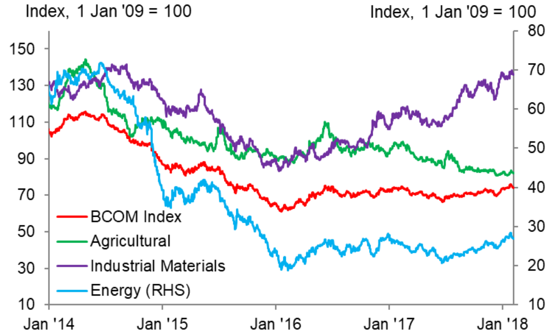
Regional Economic Developments

Improvement in the overall global environment continues to be supportive of global demand. Rising commodity prices (Chart 7) has also supported export earnings of commodity exporters in the region.

China continues to post stronger than expected growth, reporting 6.8 percent yoy growth in Q4 2017 (Chart 8). Overall, the economy grew by 6.9 percent in 2017, above the government target. The growth was mainly driven by the recovery in global demand for Chinese exports as well as a strong increase in government-supported infrastructure investment. On the banking side, China's new loans continue to grow despite the government's campaign to curb financial system risks. With USD weakness, RMB continued to appreciate against the USD along with other regional currencies.

Economic activity in Japan continues to pick up while inflation remained low, far below the target. Indicators such as Purchasing Managers' Index and Industrial Production show a pickup in economic activity (Chart 9), with exports growing by 9.3 percent yoy in December 2017. On inflation, figures showed that it continued to be below the price stability government's target of 2 percent,

Chart 7 Global Commodity Prices

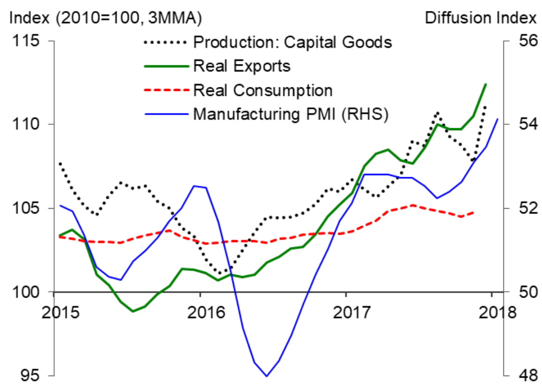


Note: The Bloomberg Commodity Index (BCOM) is made up of 22 exchange-traded futures on 20 physical commodities, which are weighted to account for economic significance and market liquidity. Among the commodities are Brent crude oil, corn, gold, natural gas, soybeans and WTI crude oil.
Source: Bloomberg

Chart 8 China grew at 6.8 percent yoy in Q4 2017

Source: National Bureau of Statistics

Chart 9 Indicators showed strong pick-up in economic activity in Japan

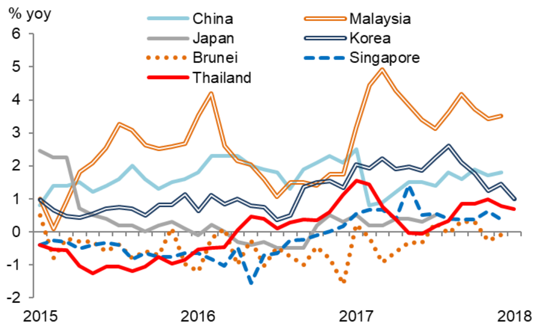


Source: Bank of Japan, Ministry of Internal Affairs and Communications prompting the BOJ to continue its "QQE with YCC" in December 2017. In the financial market, JGB yields inched up in early 2018 and the JPY strengthened against the USD in February due to heightened risk aversion.

In the region, GDP data releases show generally robust growth but slight moderation in some economies in Q4 2017 (Annex 1). While growth was sustained in China, Indonesia and Vietnam, there was a slight slowdown for Korea, the Philippines and Singapore. The slowdown in these economies was mainly contributed by slower export growth. In Korea, the export growth slowdown was a result of a long 10-day holiday in October and base effects from strong Q3 growth.

Monetary conditions remain accommodative with inflation moderating slightly, despite increases in commodity prices in recent months (Chart 10). Central banks in the region such as Japan, Indonesia and Myanmar held interest rates whereas Malaysia raised its overnight policy rate as a pre-emptive measure to avoid buildup of risks as the economy continues on its growth path. While regional inflation remains benign, monetary policy space is narrowing as global financial conditions tighten.

Chart 10 Regional inflation continues to be benign



Source: National Authorities

Annex 1: Annual GDP Growth Figures for Selected ASEAN+3 Economies

Economy	Annual GDP Growth, % y-o-y					
	2015	2016	1Q'17	2Q'17	3Q'17	4Q'17*
China	6.9	6.7	6.9	6.9	6.8	6.8
Hong Kong	2.4	2.0	4.3	3.9	3.6	-
Japan	1.4	0.9	1.5	1.6	2.1	-
Korea	2.8	2.8	2.9	2.7	3.8	3.0
Brunei	-0.4	-2.5	-1.7	0.7	1.2	-
Indonesia	4.9	5.0	5.0	5.0	5.1	5.2
Malaysia	5.0	4.2	5.6	5.8	6.2	-
Philippines	6.1	6.9	6.4	6.7	7.0	6.6
Singapore	2.0	2.0	2.5	3.0	5.4	3.1
Thailand	2.9	3.2	3.3	3.8	4.3	-
Vietnam	6.7	6.2	5.2	6.3	7.5	7.7

Source: National Authorities, Bloomberg, CEIC

* Data not released as of 7 February 2018

Annex 2: Global Manufacturing PMI Heatmap

Economies	2015				2016				2017												2018	Change from Prev Month	Trend (with min and max pts)
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan		
Global																						-0.1	
Developed Markets																						0.1	
U.S.																						0.4	
U.K.																						-0.9	
Eurozone																						-1.0	
Austria																						-3.0	
France																						-0.4	
Germany																						-2.2	
Greece																						2.1	
Ireland																						-1.5	
Italy																						1.6	
Netherlands																						0.3	
Spain																						-0.6	
Emerging Markets																						-0.3	
Brazil																						-1.2	
India																						-2.3	
Russia																						0.1	
South Africa*																						0.6	
																						0.0	
China																						0.0	
Hong Kong*																						-0.4	
Japan																						0.8	
Korea																						0.8	
ASEAN																						0.3	
Indonesia																						0.6	
Malaysia																						0.6	
Philippines																						-2.5	
Singapore*																						1.5	
Thailand																						0.2	
Myanmar																						0.6	
Vietnam																						0.9	

Note: These seasonally adjusted PMI readings are coded by colors:

- Darker shades of red in the reading denote readings further below (< 45) the diffusion level of 50; conversely, greener shades in the readings denote readings further above (> 55) the diffusion level of 50.
- The trend lines shown in the right-most column represent the PMI readings since January 2015, the red dots denote minimum and maximum points in that period.
- Global PMI is as aggregated by JP Morgan. China's PMI refers to Caixin/ Markit PMI.
- (*) denotes whole economy PMI

Source: Markit, JP Morgan

Annex 3: Major Policy Developments (1 January – 5 February 2018)

China	[08 January 2018] The People's Bank of China (PBC) and the Bank of Thailand (BOT) signed the Extension and Amendment Agreement to extend the Renminbi – Thai Baht Bilateral Swap Agreement (BSA). Under this BSA, the amount of RMB 70 billion or THB 370 billion shall be made available for a period of 3 years. [06 January 2018] China Banking Regulatory Commission (CBRC) published "Entrusted Loan Management Rules for Commercial Banks". This is to further regulate commercial banks' entrusted loan business, enhance risk management, and to better serve the real economy. Under this rule, banks can only act as intermediaries when arranging entrusted loans, and must not provide guarantees or get involved in decision-making. [05 January 2018] China Banking Regulatory Commission (CBRC) published "Regulation on Commercial Banks' Equity Investors", aiming to enhance regulation on commercial banks' shareholders, to regulate shareholders' behavior and to fill in the regulatory gap.
Hong Kong, China	[10 January 2018] HKMA announced that the countercyclical capital buffer (CCyB) for Hong Kong will increase to 2.50% with effect from 1 January 2019, from the current 1.875%.
Indonesia	[18 January 2018] Bank Indonesia (BI) held the BI 7-day Reverse Repo Rate at 4.25%, while maintaining the Deposit Facility (DF) and Lending Facility (LF) rates at 3.50% and 5.00% respectively. In addition to, BI also decided to accelerate the implementation of average minimum reserve requirement ratios as a follow up on the monetary policy operational framework reform and refined the macroprudential policy by implementing two regulations to encourage bank intermediation function.
Japan	[23 January 2018] The Bank of Japan decided to keep the short-term policy rate unchanged at negative 0.10% and the 10-year yield target around 0.00%.
Korea	[18 January 2018] Monetary Policy Board of the Bank of Korea (BOK) decided to keep policy rates unchanged at 1.50%.
Malaysia	[25 January 2018] Bank Negara Malaysia (BNM) raised the overnight policy rate (OPR) by 25 bps to 3.25%.
Myanmar	[30 January 2018] Central Bank of Myanmar kept interest rates unchanged and announced that there are no plans to change existing rates until 2020. The Central Bank Rate is 10.00% p.a. The minimum Bank Deposit Rate is 8% p.a., while the maximum Bank Lending Rate is 13.00% p.a.

Feature: U.S. Tax Reform and Implications on Regional Emerging Markets

Main Provisions in TCJA

U.S. President Trump signed the Tax Cuts and Jobs Act (TCJA) into law on 22 December 2017. The TCJA is the most significant tax reform since the 1980s, through lowering personal income and corporate taxes, as well as moving from a worldwide to a partially territorial system of international taxation (see Table 1).

While the cuts in personal income tax rates are marginal and would mostly expire at end of 2025, the **cut in corporate income tax from 35 percent to 21 percent is large and permanent**.

The other significant change is the **move from a worldwide system of international taxation to a territorial system**, where corporates would be taxed only on income earned within the U.S. The territorial system is only partial as there are provisions that continue to tax U.S. multinational companies' (MNCs) accumulated income parked overseas.

Table 1. Key Tax Changes in TCJA

Personal Income Taxes

- Lowers most personal income tax rates, including the top marginal rate from 39.6 percent to 37 percent. Retains the current seven-bracket structure, but bracket widths are modified.
- The majority of individual income tax cuts are temporary and would expire on 31 December 2025.

Corporate Taxes

- Lowers the corporate income tax rate permanently from **35 percent to 21 percent**, starting in 2018.
- Allows full and immediate expensing of short-lived capital investments for five years.
- Limits the deductibility of net interest expense to 30 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA) for four years, and 30 percent of earnings before interest and taxes (EBIT) thereafter.

International Taxation

- Moves from a worldwide system of taxation to a **territorial system**, where corporates are taxed only on income earned within the U.S.
- To prevent erosion of tax revenue during the transition, there are provisions that would have a one-off effect on U.S. MNCs through taxing their accumulated earnings abroad.

Source: AMRO's compilation from U.S. official sources.

Potential Macroeconomic Spillover Channels to ASEAN+3 Region

The TCJA could have macroeconomic spillover effects on emerging markets, including on the ASEAN+3 region, through three main channels:

a. **Raising U.S. economic growth** through tax cuts boosting U.S. domestic consumption and investment;

b. Through **increasing the U.S. budget deficit** in future, raising U.S. Treasury yields and pulling up sovereign yields globally; and

c. If the U.S. Federal Reserve ("Fed") assesses U.S. inflationary pressures to rise as a result of TCJA, the **Fed may raise policy rates at a faster pace** than the expected three rate hikes in 2018. This would tighten global financial conditions faster than expected and if not well communicated by the Fed, may trigger capital outflows from emerging markets.

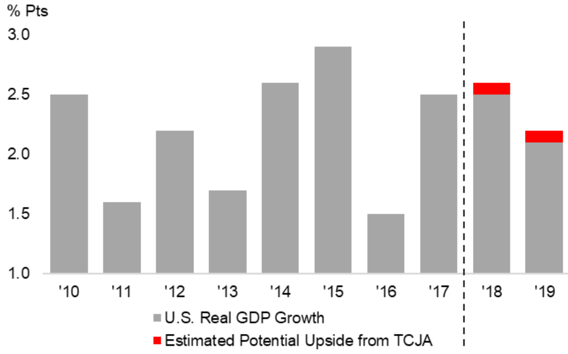
Of these three channels, the first channel of boosting U.S. economic growth would be positive, while the other two are potentially negative to the region.

a. <u>Limited boost expected to U.S. economic growth</u>

The U.S. Congress' Joint Committee on Taxation estimates that the TCJA would increase **real GDP growth annually on average by about 0.7 percentage points** relative to baseline growth in the decade ahead.[2] Private sector consensus forecasts are lower, with the estimated boost ranging from +0.2 to +0.4 percentage points (Figure 1).

The **potential upside to U.S. economic growth is limited** as the economy is near full employment.

Figure 1. U.S. Real GDP Growth with Estimated Boost from TCJA

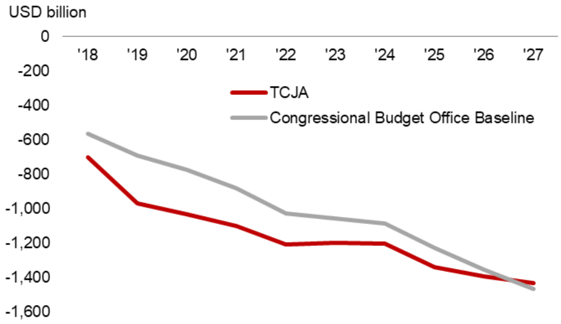


Source: Bloomberg

b. <u>Projected rise in U.S. budget deficit may pull up U.S. Treasury yields further</u>

The TCJA is not revenue-neutral and is projected to **increase the U.S. budget deficit by USD 1.456 trillion cumulatively in the first ten years** (2018-27). Thereafter, the rise in budget deficit will taper off as personal income tax cuts expire (Figure 2).

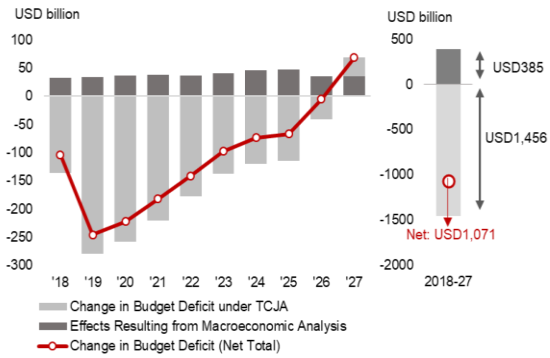
Figure 2. U.S. Budget Deficit Outlook Under the TCJA (2018-2027)



Source: Congressional Budget Office, Joint Committee on Taxation

This increase in the budget deficit may be ameliorated by positive supply-side response, whereby the increase in economic growth will increase tax revenue collections. The U.S. Joint Committee on Taxation estimates that after accounting for positive supply-side effects, TCJA will still increase the budget deficit increase by USD 1.071 trillion cumulatively over 2018-27 (Figure 3).

Figure 3. Estimated Annual Change in U.S. Budget Deficit Under the TCJA (2018-2027)



Source: Joint Committee on Taxation

Markets have largely priced in the projected increase in the U.S. budget deficit through rising U.S. Treasury yields, which have

[2] Joint Committee on Taxation, Macroeconomic Analysis of the Conference Agreement for H.R. 1, the "Tax Cuts and Jobs Act" (JCX-69-17), 22 December 2017 (www.jct.gov).

been rising since the beginning of 2018 (Figure 4).

c. Fed response: maintain pace of rate hikes

Although U.S. Treasury yields have risen, global financial conditions have not tightened excessively as the Fed signalled its intention to maintain its pace of three rate hikes in 2018. At an FOMC press conference, Fed Chair Yellen noted that:

"…my colleagues and I are in line with the general expectation among most economists that the type of tax changes that are likely to be enacted would tend to provide some modest lift to GDP growth in the coming years…"

Fed Chair Yellen, 13 December 2017

The Fed also noted that expectations of changes to fiscal policy over the past year have been reflected in financial market conditions.

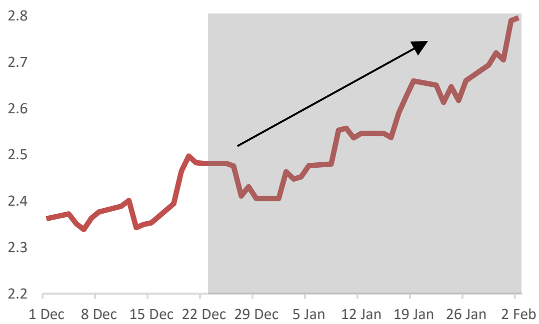
Overall assessment of potential macroeconomic spillovers

With the limited boost to U.S. economic growth from TCJA, positive spillovers to the region through increased U.S. demand for exports would be limited. The potential negative spillovers from sharp spikes in U.S. Treasury yields and a faster-than-expected pace of U.S. Fed rate hikes have also not materialised, but these are risks that bear watching as the macroeconomic impact of TCJA becomes clearer.

Potential Impact on U.S. MNCs' Activities Overseas

In addition to these macroeconomic channels, **the TCJA may potentially change the tax considerations of U.S. MNCs in investing or parking their earnings overseas, although rates of return on good investment opportunities in host countries, such as in Asia, may continue to outweigh tax savings under TCJA.**

Figure 4. Rising U.S. Treasury Yields



Source: Bloomberg

While it has been suggested that the U.S. corporate tax rate cut in itself could induce some shifting of investment to the U.S. from other OECD countries, the tax rate cut to 21 percent actually brings the U.S. rate closer to the OECD average, not significantly below (Table 2). It is unlikely that the U.S. corporate tax rate cut would trigger a round of global tax competition.

The more significant change is the shift from **a worldwide system of international taxation to a partial territorial system.** As the TCJA still imposes a tax on U.S. MNCs' cash and liquid assets accumulated abroad[3] – hence not a "pure" territorial system – there may be a one-off negative impact on MNCs with significant earnings currently parked abroad.

The TCJA also contain provisions to combat "profit shifting" and "base erosion" that on balance, appear to impact host countries where U.S. MNCs have parked "intangible assets" for tax purposes (such as patents, copyright and trademarks), or where they have significant intra-group financial transactions.[4] **Insofar as these "intangible assets" and transactions are more significant for U.S. MNCs in developed markets such as the EU rather than Asia, the EU may be more affected**. The U.S. MNCs are still studying the impact of the TCJA on the location of their operations overseas, with the actual impact on U.S. MNCs' investment activities in the ASEAN+3 region still uncertain. On balance, however, the rates of return on good investment opportunities in host countries, such as in Asia may continue to outweigh tax considerations under TCJA.

Table 2. Corporate Tax Rate Comparison

Country	Corporate Tax Rate	VAT
U.S.	21%	-
Other OECD		
UK	19%	20%
Germany	15.8%	19%
Japan	30%	8%
Australia	30%	10%
Canada	15%	5%

Source: OECD, World Bank Group, Doing Business 2018

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[3] The TCJA imposes a 15.5 percent tax on cash and liquid assets accumulated abroad between December 1986 and December 2017 and an 8 percent tax on income reinvested abroad over the same period. Based on estimates by the Joint Committee on Taxation, the one-time impact could cost U.S. MNCs USD 339 billion over the next decade.

[4] The TCJA also introduces a "base erosion and anti-abuse tax (BEAT)." The TCJA works like an alternative minimum tax by requiring firms to calculate what their U.S. taxable income would be if they disregard deductions for cross-border payments to foreign affiliates. To the extent that a tax at the rate of 10 percent on this alternative tax base exceeds the tax at the rate of 21 percent on the normal tax base, the firms must pay the difference. The BEAT is estimated to cost U.S. MNCs USD 150 billion over the next decade.