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

ASEAN+3 Macroeconomic Research Office (AMRO)

Singapore

September 2018

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

Unless otherwise indicated, the analysis in this report is based on information available up to 14 September 2018. For the sake of brevity, "Hong Kong, China" will be referred to as "Hong Kong" in the text and figures.

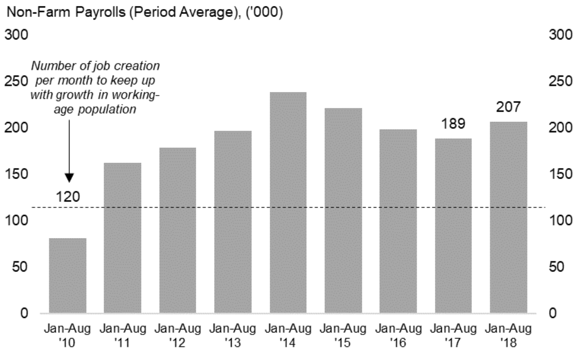
Global Economic Developments

The U.S. economy continue to grow robustly in Q3 2018, with the August jobs report pointing to the fastest annual wage increases since 2009. Non-farm payrolls surged by 201,000 jobs in August 2018, boosted mainly by hiring in the construction, wholesale and business services. Average job creation has consistently stayed above the 200,000 level per month (Figure 1), reflecting the robust labor market conditions at a time when the economy is growing above trend-growth. [1] While the unemployment rate remains unchanged at 3.9 percent in August, the tightening labor market conditions have gradually translated into stronger wage increases, which recorded the fastest growth since 2009 (Figure 2). Underlying price pressure, as measured by the core inflation has continued to stay near the 2 percent level in August 2018.

The Fed is widely expected by markets to normalize policy interest rates further, with market participants pricing in a 25 bps hike in the September FOMC meeting. So far, the incoming data remains strong, suggesting that the Fed is likely to continue its gradual rate hikes towards the neutral level, currently estimated by Fed officials at around 3 percent.

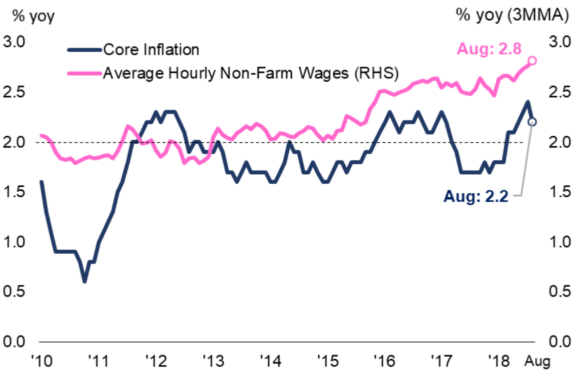
In the Eurozone, economic sentiment improved for the second month running in August 2018, while in the U.K., economic activities picked up but underlying growth is expected to remain weak. Eurozone economic activities have been stronger than anticipated, with upside surprises led by Germany and the Netherlands in Q2 2018. [2] Going into Q3 however, the outlook remains cautiously optimistic, given recent market turmoil in Turkey, notwithstanding the uptick in overall economic sentiment for the second month running in August (Figure 3). In the U.K., while growth has

Figure 1
U.S. employment growth remains robust, rising to 207,000 jobs on average in Jan-Aug 2018…



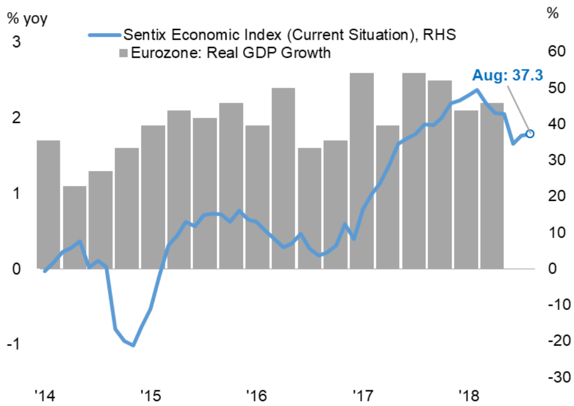
Source: BEA

Figure 2
…while wages recorded the fastest annual increase in nine years.



Source: BEA

Figure 3
Eurozone economic sentiment indicator improved further in August 2018, as trade fears eased.



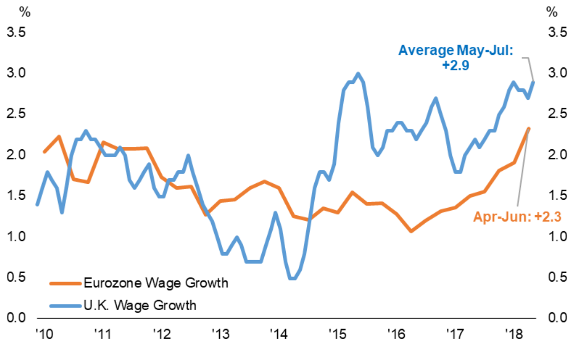
Notes: The Eurozone economic sentiment index refers to the Sentix Economic Index on current situation. A reading above zero indicates optimism; below indicates pessimism.
Source: EuroStats, Haver Analytics

[1] Estimates of Q2 2018 real GDP growth in the U.S. has been revised upwards by 0.1 percentage points to 4.2 percent annualized rate (Q1 2018: +2.2 percent).
[2] Eurozone Q2 2018 real GDP growth has been revised upwards by 0.1 percentage points to 2.2 percent yoy (Q1 2018: +2.1 percent).

stabilized in Q2 2018 with an uptick expected in Q3, underlying growth momentum remain modest by historical standards. This reflects partly weak factory activities, which continued to fall back from its high point at the end of last year (see Annex 2). Similar to the U.S., in both economies, wage growth has gradually firmed, reflecting the improvement in labor market conditions (Figure 4).[3]

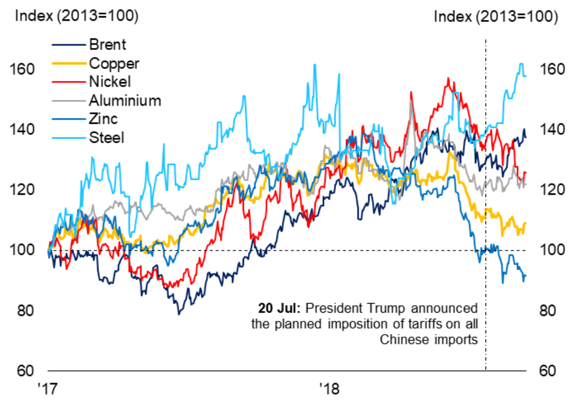
In commodity markets, global oil prices rallied slightly on concerns about an expected fall in supply from Iran and worries over Hurricane Florence. Brent crude hovered close to the USD80 barrel mark as of mid-August 2018, on concerns about the supply cuts from Iran as the U.S. has ratcheted up pressures on countries to comply with the sanctions on Iran which will come into full effect on 4 November 2018.[4] Concerns about potential supply disruptions from Hurricane Florence also kept prices elevated (Figure 5). Base metal prices (such as copper and zinc) remain sluggish, reflecting the uncertainty over the implementation of the next round of trade tariffs by the U.S. In contrast, steel prices have surged by about 40 percent since March.

Figure 4
In both Eurozone and the U.K., wages have gradually trended higher.



Notes: Eurozone wages refer to quarterly compensation of employees, while U.K wages refer to average earnings (regular pay, excluding bonuses).
Source: Haver Analytics

Figure 5
Global oil prices have trended upwards, while major base metal prices remain relatively weak

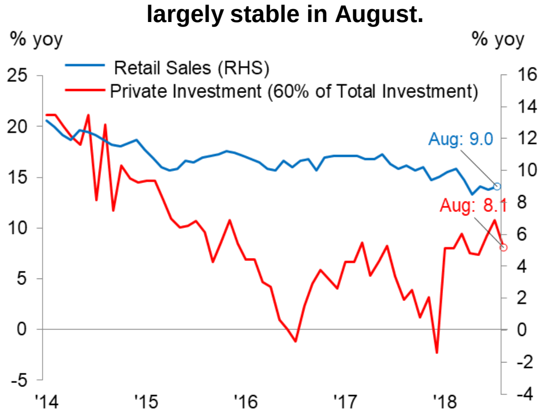


Source: Haver Analytics

Regional Economic Developments

In China, monthly indicators suggest that economic activities continue to be largely stable, with expanding production and private investment. While retail sales activities have shown some moderation, so far, overall growth has been supported by fairly robust external demand, with July export growth registering 10.6 percent (Jun 2018: +11.4 percent). However, looking ahead, official PMI indicator for new export orders continue to remain somewhat soft in August indicating a moderate pace of factory output in Q3 2018.

Figure 6
China's economic activities continue to be largely stable in August.

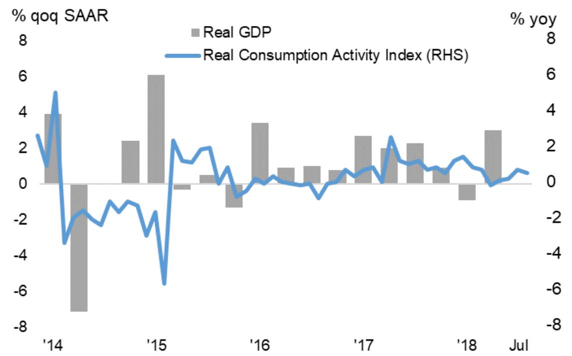


Source: NBS

[3] In the Eurozone, unemployment rate (SA) has fallen to 8.2 percent in July 2018, similar to the average 2006 level (pre-Global Financial Crisis). In the U.K., the unemployment rate (SA) has also dropped to the lowest level for over 40 years (Jul 2018: 4.0 percent).
[4] This represents the second and more significant stage where sales of oil, gas and refined petroleum products will be restricted.

In Japan, economic activities remain robust, driven by the acceleration in capital expenditures and exports. The pace of Japan's economic growth quickened to its fastest pace in more than two years[5], driven by the expansion in corporate capital spending, and still favorable export demand. The outlook for Q3 is likely to be more moderate, judging from the slower pace of consumption growth in July, and the potential negative impact from weather-related/natural disasters during the quarter (Figure 7). Headline inflation readings in July 2018 remain close to 1 percent level, with stable core inflation (CPI ex-fresh food) at 0.8 percent.

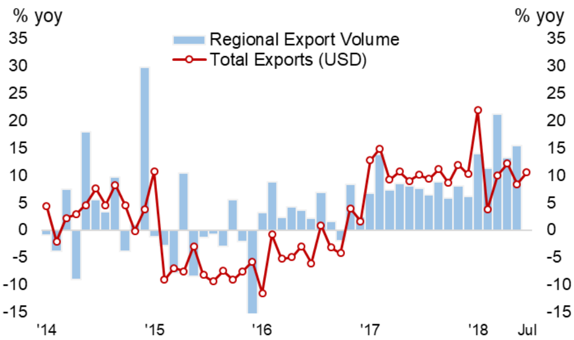
Figure 7
While Japan's economic growth has been stellar, the outlook for Q3 is likely to be more moderate.



Source: National Authorities

Other regional economies reported slightly slower growth readings in Q2 2018 (Annex 1), with PMI indicators suggesting that the moderate outlook is likely to continue into Q3. On the exports side, regional export volume growth has held up relatively well in July, considering the slight correction from a surge in Q1 this year. This has help to mitigate the temporary weakness (such as slower tourism activities in Thailand, and adverse weather-related conditions that affected agriculture production in Malaysia).

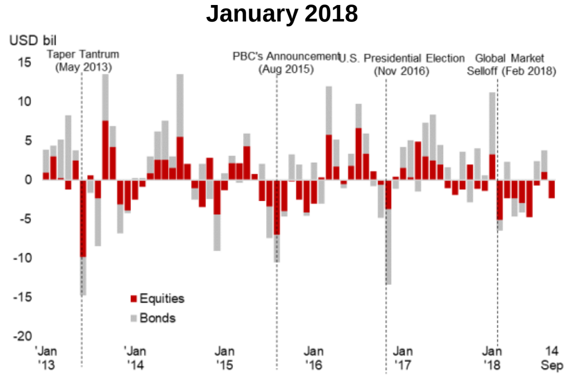
Figure 8
So far, regional exports have held up relatively well



Source: National Authorities, AMRO staff calculations

Foreign capital flows in regional EMs have largely turned to net outflows since early 2018, weighed down by stronger USD and rising U.S. Treasury yields amid tighter global financial conditions. Unlike the relative calm in 2017, concerns about escalating trade tensions and to some extent, rising inflation, particularly in the U.S., have sent global market volatility higher since early 2018. Exacerbating this uneasy global backdrop is the turmoil in other EM regions (e.g. Argentina and Turkey), triggering a risk-off sentiment across EM assets (see Special Feature). In Jan-Aug 2018, cumulative net capital capital outflows stood at USD4 billion, with another USD2 billion in net equity outflows in the first 2 weeks of September 2018.

Figure 9
Foreign portfolio capital flows in the region have largely turned to net outflows since January 2018



Note: Data for equities are up to 14 September 2018, while data for bonds are up to end-August 2018.
Source: National Authorities

[5] Japan's Q2 2018 real GDP data has been revised upwards to 3.0 percent annualised rate (preliminary reading: 1.9 percent annualised rate).

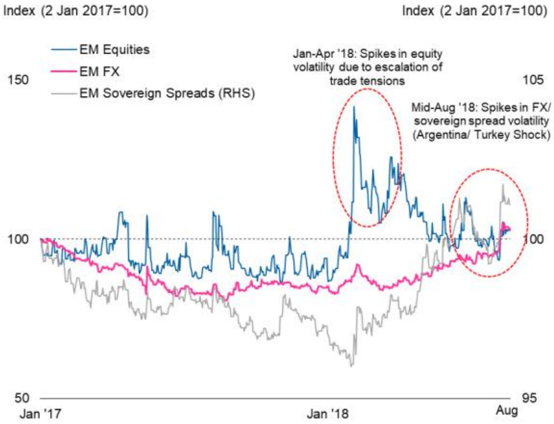
Special Feature: Recent Market Turmoil in Argentina and Turkey and Spillovers to Regional EMs

Global Backdrop

- The **recent market turmoil in other EM regions has exacerbated the uneasy global backdrop**, with growing risk aversion towards EM assets given the crisis in Argentina, and more recently in Turkey, sending EM asset price volatilities higher since early 2018 (Figure A).

- The weakness in EM asset performance so far, reflects a **confluence of factors**, from common global factors (such as U.S. Fed policy), to **country-specific idiosyncratic risk factors** (such as widening macroeconomic imbalances in Argentina and Turkey, and concerns about China's growth amid on-going domestic deleveraging and economic impact of U.S. tariffs on Chinese imports).

Figure A. Asset Price Volatilities (Selected EM Asset Classes)



Note: Data as of end-August 2018.
Source: Bloomberg

Argentina and Turkey: Macroeconomic Fundamentals and Underlying Vulnerabilities

- The crises in Argentina and Turkey reflect the **growing macroeconomic imbalances in both economies which have been building for some time**, notably:

  (1) **Growing current account deficits.** In Argentina and Turkey, the current account deficits have been driven by strong imports, reflecting the robust domestic demand amid supportive macroeconomic policies. The widening deficit (Figure B) and high inflation in turn combined to generate sustained exchange rate overvaluation (in real effective terms), which is a key source of macroeconomic imbalances.

  (2) **Growing private short-term external debt**. The current account deficits have been financed by **private short-term foreign debt capital**, which has grown very large. Turkey, in particular, has the highest stock of private short-term external debt amongst EMs that run current account deficits. Tighter global

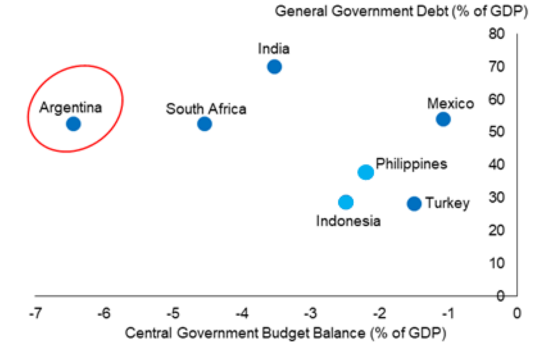
Figure B. Current Account Deficits & Private Short-Term External Debt (2017), Selected EMs*

* EMs that are running current account deficits. Regional EMs are shown in light blue.
Source: QEDS World Bank, AMRO ERPD Matrix, IMF, Haver Analytics

financial conditions and strengthening USD are posing downward pressure on the peso and lira, raising questions about the sustainability of FX-denominated debt, as well as re-financing risks.

(3) **Widening fiscal deficit and ballooning debt (in Argentina).** The Argentine central government budget deficit widened to more than 6 percent of GDP in 2017 (Figure C), with relatively high debt mostly in foreign currency.

Figure C. Fiscal Position (2017), Selected EMs*



* EMs that are running current account deficits. Regional EMs are shown in light blue.
Source: National Authorities, IMF

Channels of Risk Transmission & Potential Contagion to Regional EMs

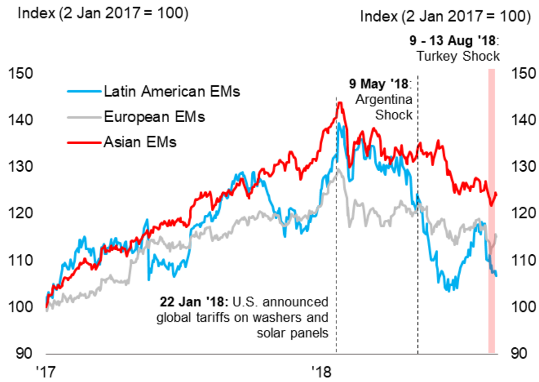
- The financial stress in Argentina and Turkey can be transmitted to ASEAN+3 region via three key financial channels; **(1) asset prices, (2) EM index performance channel and (3) regional bank lending to Turkey (direct, and indirect via Eurozone banks)**.

(1) Asset Prices

❖ So far, in terms of asset prices, **market participants continue to discriminate between regional EMs and other EMs outside the region based on economic fundamentals**.

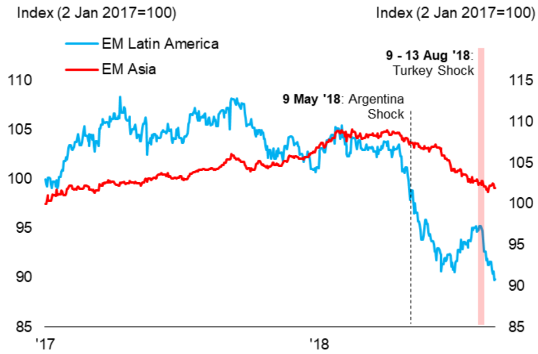
- The spillover effects from both Argentina and Turkey shocks were relatively limited, as EM Asia's equities and currencies did not see a large and sustained selloff/reversal (Figures D, E). For instance in the equity markets, during the recent Turkey shock (9 to 13 August 2018, where the lira depreciated by close to 20 percent), EM Asia saw a 2 percent decline in equities, as compared to 3 percent in EM Europe, and 7 percent in EM Latin America.

Figure D. Equity Market Performance
(a) EM Asia vs Other EM Regions



Note: The Argentine Shock refers to the period 2 to 14 May 2018, characterized by a nearly 20 percent slide in the peso. On 9 May 2018, the government officially announced that it is seeking IMF aid.
Source: Bloomberg

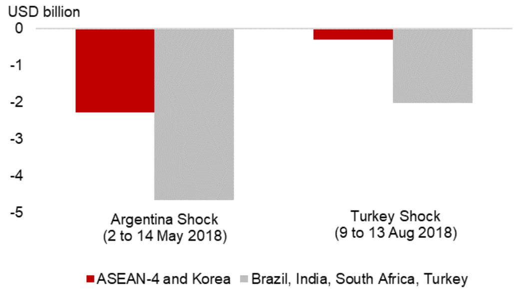
Figure E. FX Market Performance (Against USD)
(a) EM Asia vs Other EM Regions



Notes: EM Asia currency (ADXY) refers to China, Hong Kong, Korea, Malaysia, Indonesia, Thailand, the Philippines, Singapore, India, and Taiwan Province of China. While EM Latin America currency (LACI) refers to Argentina, Brazil, Chile, Colombia, Peru and Mexico.
Source: Bloomberg

- In terms of capital flows, there were some selloffs in foreign portfolio capital in ASEAN-4 and Korea, but the magnitude of the selloff was relatively less during both Argentina and Turkey Shocks (Figure F).

Figure F. Foreign Portfolio Net Capital Flows: Comparison between Argentina and Turkey Shock (USD billion)



Source: Bloomberg

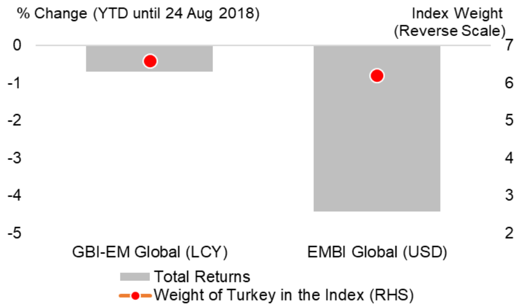
(2) EM Index Performance

❖ **Apart from asset prices, the spillovers from Turkey could weigh on cross border capital flows in regional EMs through the index performance channels.**[6]

- So far, notwithstanding that the positioning in Turkey has been relatively light even prior to recent events, **Turkey's weight in major global EM aggregate credit index is non-negligible** (Turkey's weight in EMBIG Index: 6.2 percent) (Figure G). The turmoil in Turkey has contributed to the negative index returns on a year-to-date basis (until 24 Aug 2018).

- Looking ahead, the **negative index performance could have a potential negative feedback loop for future EM cross border fund flows** in the event Turkey (or other major EMs in the benchmark index) continues to underperform.[7]

Figure G. EM Credit Index Returns and Turkey's Weight in the Index



Note: The GBI-EM Global refers to the Global Diversified series.
Source: Bloomberg

(3) Exposure of Regional Banks to Turkey

❖ The risk transmission to the region via the bank lending channel is characterized by the following: (1) Direct exposure (lending by regional banks to Turkey (all sectors)), and (2) Indirect exposure (lending by

[6] Fund managers (such as in mutual funds and ETFs) typically benchmark their portfolio investment performance against the performance of some aggregate indices. The J.P. Morgan's EMBI Global (EMBIG) Index is a typical example.
[7] A relevant case in point is the passively managed index products, i.e. those designed to track a benchmark index, and is usually comprised the same securities and at the same weights as the index on which it is based

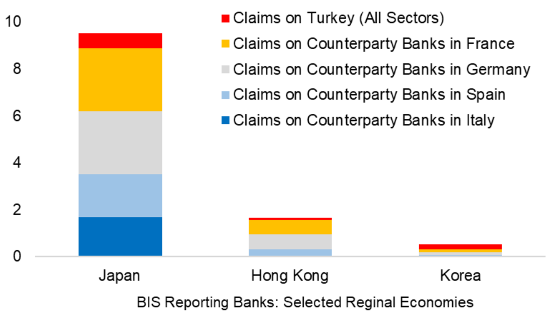
regional banks to Turkey via major Eurozone banks).

- **Direct exposure**: According to BIS data, regional banks' (Japan, Korea and Hong Kong) **direct bank lending exposure to Turkey's financial and corporate sectors is relatively limited**, accounting for less than 1 percent of Turkey's GDP in 2017 (Figure H). In contrast, U.K., Germany and France have higher direct exposures, reflecting the close proximity to Turkey.

- **Indirect exposure**: While several major Eurozone banks (such as BBVA and UniCredit) have sizeable lending exposure to Turkey (Table 1), regional banks' indirect exposure to Turkey via Eurozone banks' lending activities[8] is relatively small as well – the largest being Japan only (Figure H), suggesting that the indirect exposure to Turkey via Eurozone lending is not likely to be large.

❖ Preliminary analysis by AMRO on the financial sector interconnectedness (or the likelihood that two financial institutions in different economies would get into distress together) shows **that only 2 of the 5 top Turkish banks are strongly connected to the financial sectors in Germany and France, and none with the region**. This corroborates the notion that bank distress in Turkey (on a direct exposure basis), is unlikely to have material spillovers to the region (Table 2).

Figure H. Regional Banks' Claim vis-a-vis Turkey, and vis-à-vis Counterparty Banks in Major Eurozone Economies



Notes: Figures refer to the cross border banking claims of Japan, Hong Kong and Korea banks vis-à-vis counterparties in Turkey (all sectors), and cross border claims vis-à-vis major Eurozone and U.K. counterparty banks only. Reporting banks include domestic and foreign banks/consortium, and covers claims in all currencies.
Source: BIS, AMRO

Table 1. Cross Border Bank Lending/Exposure of Selected Major Eurozone Banks to Turkey

Selected Eurozone Banks	Exposure to Turkey (2017)
	% of Total Loans
BBVA (Spain)	11.4
UniCredit (Italy)	9.1
BNP (France)	6.7
ING (Netherlands)	1.5
HSBC (U.K.)	0.4

Source: Individual banks' financial statements

Table 2. Interconnectedness between Financial Sectors in Europe and in the Region vis-à-vis Turkey's 5 Largest Banks (by Asset Size)

	Top 5 Turkish Banks by Asset Size				
	Turkiye Is Bankasi	Turkiye Garanti Bankasi AS	Akbank TAS	Yapi ve Kredi Bankasi AS	Turkiye Halk Bankasi AS
U.K.					
Germany		√			
France					√
Italy					
Spain					
Region*					

* Except Brunei, Cambodia, Lao PDR and Myanmar.
Notes: The connectedness is measured by default correlation. The connectedness in the analysis, based on data up to June 2018, is said to be strong (denoted by a "√") if a Turkish bank tends to default disproportionately more frequently with the corresponding financial institutions in the economy indicated in the table.
Source: The Credit Research Initiative of the National University of Singapore, AMRO staff calculations

Policy Priorities

Considering the more challenging global backdrop, **it would be prudent for regional authorities to prioritize financial stability while continuing to build buffers to prepare for future risks**. For economies facing strong external headwinds amid growing structural vulnerabilities, the authorities can consider **implementing pre-emptive policy measures, including where appropriate, undertaking frontloaded and ahead of the curve policy calibrations to maintain confidence in the economy**. While risks of broader EM contagion are limited so far, it is more important than ever for policymakers to remain alert and vigilant to changing global liquidity conditions.

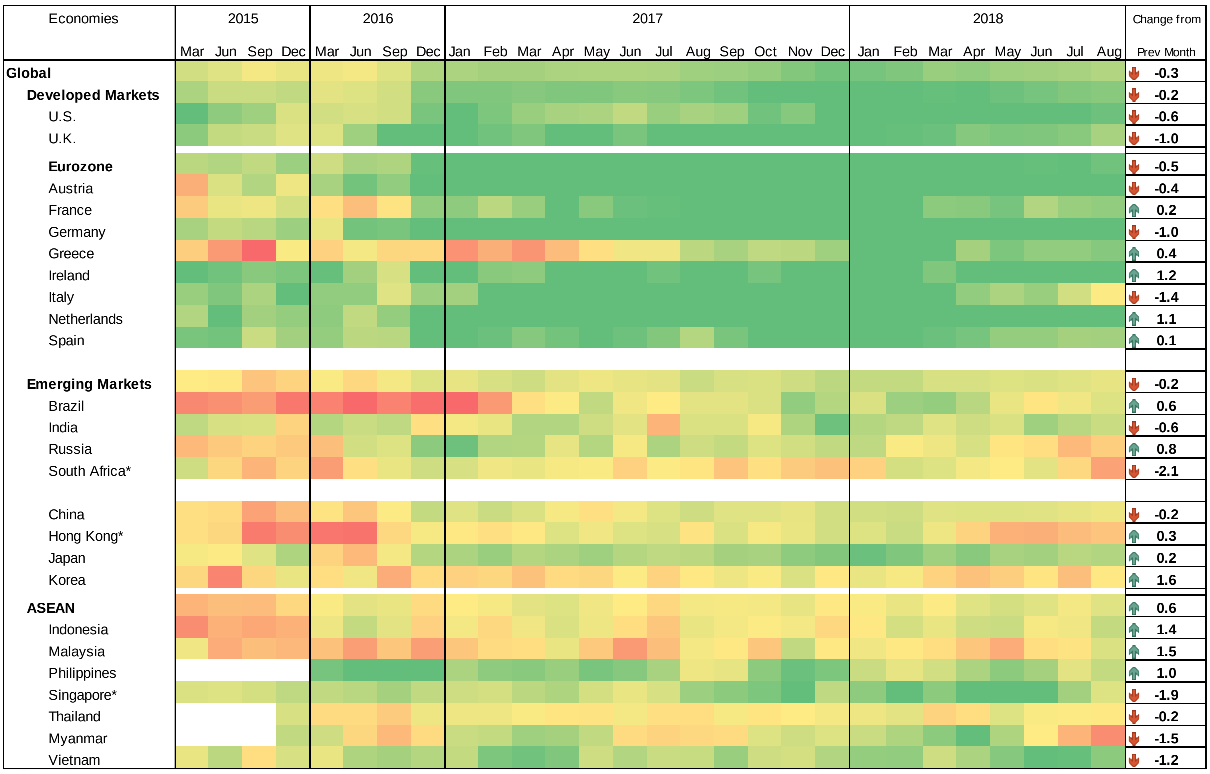
[8] Refers to regional banks' exposure to all Eurozone banks, rather than specific Eurozone banks with exposure to Turkey.

Annex 1: GDP Growth for Selected ASEAN+3 Economies

Economy	Annual Growth, % y-o-y									
	2014	2015	2016	2017	1Q'17	2Q'17	3Q'17	4Q'17	1Q'18	2Q'18
China	7.3	6.9	6.7	6.9	6.9	6.9	6.8	6.8	6.8	6.7
Hong Kong	2.8	2.4	2.0	3.8	4.4	3.9	3.6	3.4	4.6	3.5
Japan	0.4	1.4	0.9	1.6	1.5	1.6	2.0	2.0	1.0	1.0
Korea	3.3	2.8	2.8	3.0	2.9	2.8	3.8	2.8	2.8	2.8
Brunei	-2.5	-0.4	-2.5	1.3	-1.3	0.2	1.3	5.2	2.5	-
Indonesia	5.0	4.9	5.0	5.1	5.0	5.0	5.1	5.2	5.1	5.3
Malaysia	6.0	5.0	4.2	5.9	5.6	5.8	6.2	5.9	5.4	4.5
Philippines	6.2	6.1	6.9	6.7	6.5	6.6	7.2	6.5	6.6	6.0
Singapore	3.3	2.0	2.0	3.6	2.5	2.8	5.5	3.6	4.5	3.9
Thailand	0.8	2.9	3.3	3.9	3.4	3.9	4.3	4.0	4.9	4.6
Vietnam	6.0	6.7	6.2	6.8	5.2	6.3	7.5	7.7	7.5	6.8

Notes:
(1) For Japan, annual figures are based on the fiscal year ending March.
Table shows economies with latest GDP data releases since the last edition of the Monthly Update of the AREO. Data released as of 5 September 2018.
Source: National Authorities

Annex 2: Global Manufacturing PMI Heatmap



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 (7 August – 6 September 2018)

China	[24 August 2018] The People's Bank of China adjusted its methodology for fixing the yuan's daily midpoint in order to keep the currency market stable, amid broad dollar strength and ongoing trade tensions. (Link to More Information in Chinese) [6 September 2018] The Ministry of Finance will exempt interest income from loans by financial institutions to smaller firms from value-added tax (VAT) from 1 September until the end of 2020. (Link to More Information in Chinese)
Korea	[31 August 2018] The Monetary Policy Committee of the Bank of Korea decided to maintain the base rate at 1.5 percent. (Link for More Information)
Indonesia	[15 August 2018] Bank Indonesia increased its key rate – the 7-day reverse repo rate by 25 bps to 5.50 percent to maintain stability and strengthen economic resilience amid rising external risks. (Link for More Information)
The Philippines	[9 August 2018] The Monetary Board of the Bangko Sentral Ng Pilipinas (BSP) decided to raise policy rates by 50 basis points, with the BSP's overnight reverse repurchase (RRP) facility to 4.0 percent. (Link for More Information)
Thailand	[8 August 2018] The Bank of Thailand's Monetary Policy Committee decided to keep the policy rate at 1.50 percent. (Link for More Information)