



KBank Capital Markets Perspectives

How important is NEER to export growth?

**Strategies on
Macro / FX/ Rates**
1 April 2016

- ▶ **Non-conventional policies have resulted in non-normal consequences**
- ▶ **Currency strength has become number one enemy for central banks in trade-dependent EM countries**
- ▶ **Most EM Asia currencies have strengthened steadily against their trading partners**
- ▶ **We assess the sensitivity of EM Asia export growth to currency appreciation in order to deliberate the implication on central banks' policies**
- ▶ **Countries that are more reliant on external demand, namely Singapore, Malaysia, Thailand, Taiwan, and Korea will face pressure to keep their currencies competitive in order to support exports**
- ▶ **Since exports from Thailand, Korea, and Malaysia are nearly equally as sensitive to world economic growth as to currency competitiveness, these three central banks are likely to follow one another in policymaking**
- ▶ **We believe the BoT will cut rates by 25bps in Q2/16; key factors to watch are Asian central banks' move and THB NEER**

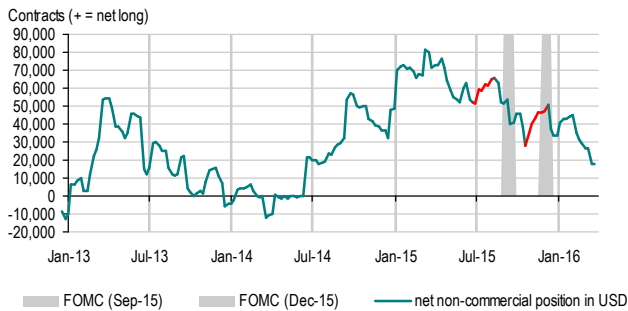
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Non-conventional policy gives non-normal consequences

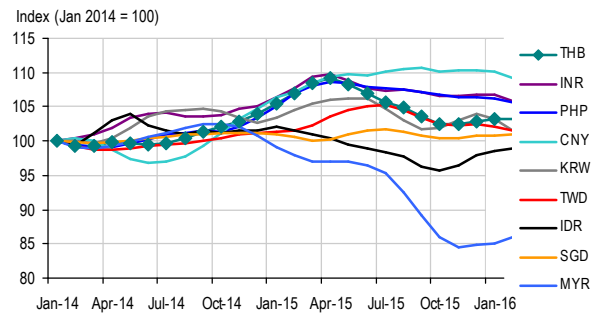
Since the Bank of Japan (BoJ) first embarked on negative rates policy and the European Central Bank (ECB) pushed its policy rates further into negative territory, **non-conventional policies have resulted in non-normal consequences**. Since central banks provide a benchmark for borrowing costs, negative rates spread to bond yields. In February 2016, more than USD 7trn of government bonds worldwide offered yields below zero (according to Wall Street Journal compilation). As returns dip further below the zero-degree threshold, emerging assets' attractiveness improved. Amidst the wake of negative rate policies, the disappearance of liquidity from the Federal Reserve (Fed)'s tightening is offset by liquidity flush from central banks elsewhere. In fact, the amount of USD long positions in non-commercial futures has gradually decreased compared to before the FOMC meeting in September and December 2015. Currency strength has become number one enemy for central banks in trade-dependent EM countries. Most EM Asia currencies have strengthened steadily against their trading partners. **Here, we assess the sensitivity of EM Asia export growth to currency appreciation in order to deliberate the implication on central banks' policies.**

Fig 1. Net non-commercial futures position in USD



Source: Bloomberg, KBank

Fig 2. Currency performance vs trading partners' currencies (NEER index)



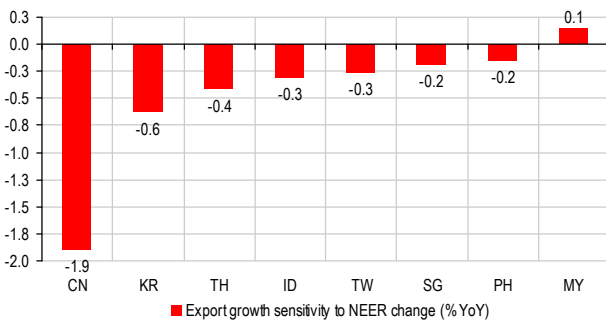
Source: Bloomberg, KBank

Whose exports are more sensitive to the ‘FX’ factor?

Using data during 2004-2015, we assess the sensitivity of each country’s exports to currency changes by running a simple regression. Our dependent variable is Asia export growth (%YoY), while our independent variable is NEER index change (%YoY). The NEER index stands for nominal effective exchange rate. It measures domestic currency value against currencies of trading partners. When the NEER rises, domestic currency appreciates against trading partners’ currencies, suggesting that a country loses export competitiveness because its goods become more expensive to buy. As simple a rule of thumb, when NEER rises, home country will experience an export decline so export growth and NEER change should have negative relationship. Our analysis shows the following result:

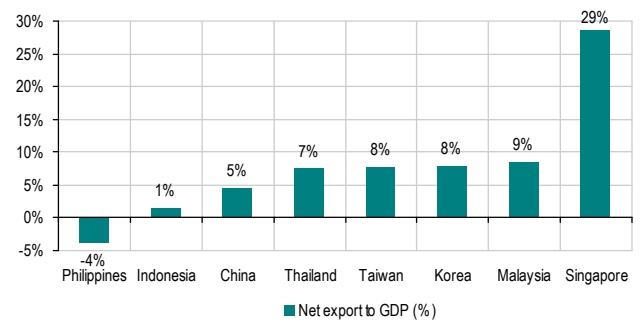
- ▶ **China** exports are the most sensitive to NEER change; if NEER rises by 1%YoY, China exports will fall by 1.9%YoY. **Korea, Thailand, and Indonesia** followed next with export sensitivities range from -0.6, -0.4, and -0.3.
- ▶ Surprisingly, **Taiwan** exports are less sensitive to NEER change. This shows that Taiwan is more insulated against currency fluctuations than former countries in the list. This is quite surprising since Taiwan is highly reliant on exports, as reflected by Taiwan’s very high net export to GDP ratio. We think Taiwan’s low NEER sensitivity could be due to the fact that its exports are determined by other factors. This could be due to its high trade-linkage with China and the world, making FX change a less significant factor.
- ▶ On the other hand, **Malaysia** exports show positive relationship with NEER change, meaning that its exports actually grow even though MYR strengthens against trading partners’ currencies. This could be attributed to Malaysia’s trade structure. Since Malaysia is a commodity-exporter, it has high trade surplus which supports the ringgit. Moreover, Bank Negara Malaysia’s restrictions on capital flows could also deter capital flows from moving freely, thus limiting MYR’s movement.

Fig 3. Asia export sensitivity to NEER change (%YoY)



Source: Bloomberg, CEIC, KBank

Fig 4. Taiwan's net export to GDP ratio

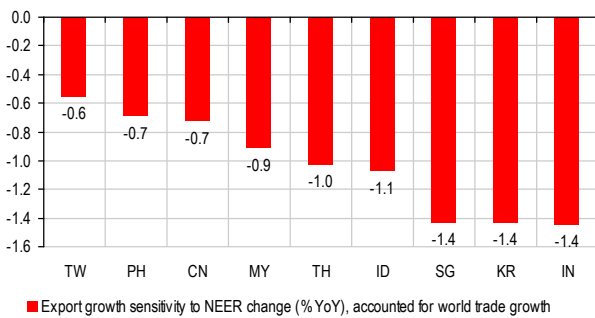


Source: CEIC, KBank

However, the above test is flawed in certain degree since it assumes that currency is the only factor that effect export growth. We, then, add another independent variable, namely world trade volume growth (%YoY), to the regression. This variable helps improve the accuracy of the test as it captures the portion of export growth that is contributed by world economic growth (using world trade volume as a proxy). The result will also show whether world economic growth or NEER change is a more important determinant for exports. The result is completely different from the first one, and shows a more complete picture:

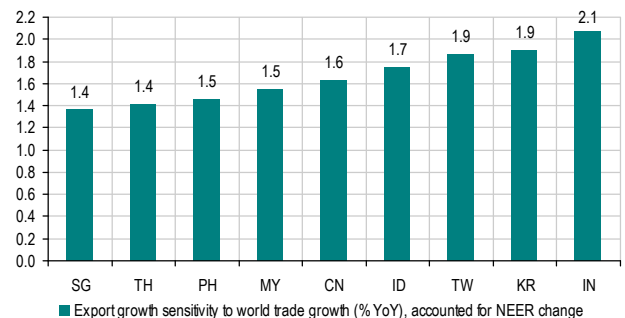
- ▶ After accounting for world trade, the countries whose exports are most sensitive to NEER change are **India, Korea, and Singapore** with a sensitivity level of -1.4. This shows that holding world trade constant, India, Korea, and Singapore exports will drop by 1.4%YoY by NEER rises by 1.0%YoY.
- ▶ Next, **Indonesia, Thailand, and Malaysia** are moderately affected by NEER change.
- ▶ In contrast, **Taiwan** is least sensitive to NEER change; this could be due to the abovementioned factors. Similarly, **Philippines**, which is a domestic-led economy, and **China**, the world's factory, showed higher tolerance for NEER change.

Fig 5. Export sensitivity to NEER change holding world trade constant



Source: Bloomberg, CEIC, KBank

Fig 6. Export sensitivity to world trade (measured in %YoY volume growth) holding NEER change constant



Source: Bloomberg, CEIC, KBank

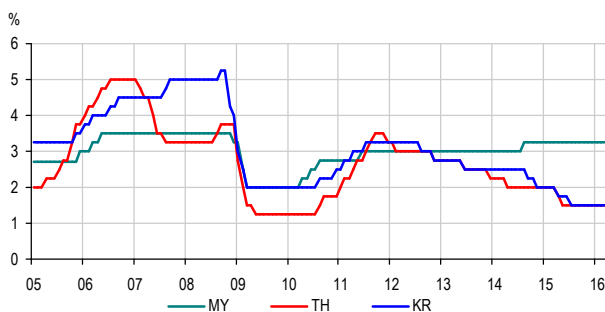
Another question worth answer is which factor is more important in dictating Asian exports between world economic growth (using world trade volume growth as a proxy) and currency competitiveness (using NEER change as a proxy). Our test result shows that world economic growth matters more for Asia exports as compared to currency competitiveness. This is depicted by the higher level of export sensitivity to world trade growth compared to NEER change in the two chats above. For example, a 1.0%YoY rise in world trade results in 2.1%YoY growth in India exports. While, a



1.0%YoY rise in NEER depresses India export by 1.4%YoY. So if we account for both factors, India export will show net positive growth.

- ▶ Looking **across selected Asia exports**, we see similar pattern in which world trade is a more important factor for export than currency change.
- ▶ However, **Singapore** is the only exception in our finding. We found that currency competitiveness is a more important factor for Singapore exports. Singapore export sensitivity to world trade is at 1.4, the same level of sensitivity to NEER change. This underscores why the Monetary Authority of Singapore prefer exchange rate-based monetary policy than inflation-targeting.
- ▶ As for **Thailand**, its export sensitivity to world trade is 1.4 and NEER change is -1.0. This shows that although world economic growth plays a dominant role in dictating Thailand exports, currency competitiveness is almost equally important since their sensitivity levels are quite close (only 4pt different).
- ▶ The same goes for **Korea and Malaysia**. Korea's export sensitivity levels to world economic growth and currency competitiveness are 1.9 and -1.4 (5pt different). Those of Malaysia are 1.5 and -0.9 (5pt different). From this, it can be said that Thailand, Korea, and Malaysia are responsive to these two factors by similar degree. This helps explain the economic synchronization between these three countries. In fact, their central banks have shown tendency to follow each other's policy moves to keep their currencies competitive as well.
- ▶ In contrast, Exports of **Taiwan, Philippines, and China** are more tolerant to currency competitiveness.

Fig 7. Thailand, Korea, and Malaysia follow the same policy rate (and economic) cycles



Source: Bloomberg, CEIC, KBank

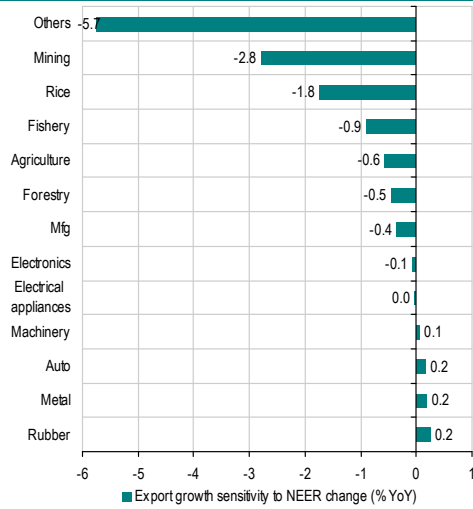
What products are more sensitive to the 'FX' factor?

Using the first analysis framework, we assessed export product sensitivity to NEER change (without accounting for world trade). We found that agricultural products (7% of export basket), are more sensitive to currency than manufacturing exports (88% of export basket).

- ▶ The sensitivity of agricultural products to NEER change is as high as -0.55, while that of manufacturing goods are -0.36.
- ▶ The sub-sectors of agricultural product group have varying sensitivity, ranging from mining (-2.79), rice (-1.75), and fishery (-0.91).
- ▶ Manufacturing sub-sectors show two different characteristics. Firstly, exports of metal products, automobiles, and machinery and equipment show positive relationship with NEER rise. This could be explained by the fact that other factors are more important in determining these products' demand. Also, Thailand is one of the largest manufacturers of the product groups, allowing it to have dominant market share and bargaining power. Secondly, exports of electrical appliances and electronics have negative relationship with NEER rise, meaning that THB

strength deters export growth of these products. This is intuitive since these products face intense competition across EM Asia.

Fig 8. Product sensitivity to NEER change



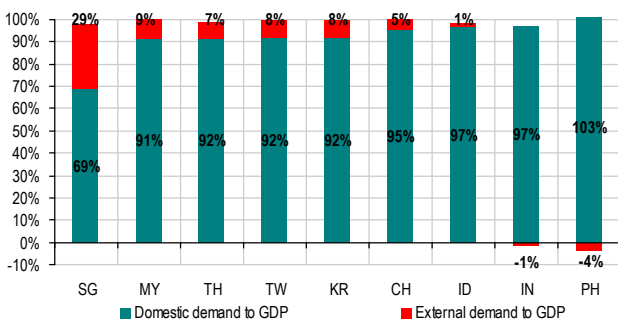
Source: Bloomberg, CEIC, KBank

Are exports and FX concerning to all Asian countries?

The countries in our study have varying degree of concern on currency change depending on the importance of exports to the overall economy. To answer the question above, we look at their economic structures. Singapore is the most vulnerable to external weakness; nearly 30% of its GDP is driven by external demand (export-import). In contrast, Philippines is relatively insulated against external weakness; its domestic demand represents 103% of GDP, while external demand subtracts 3% off GDP. India and Indonesia also depend less on external demand (1% of GDP).

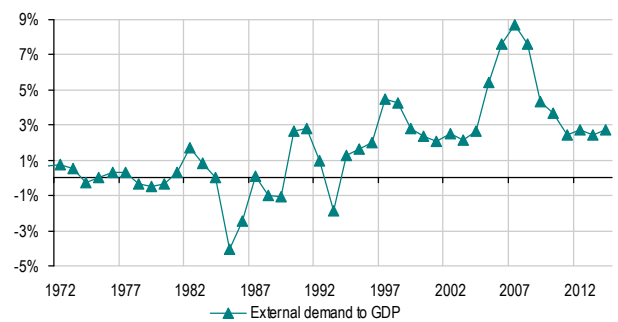
Another important key takeaway is that China's witnessing a change in economic structure. From the graph below, it can be seen that China's reliance on external demand had risen steadily after China joined the World Trade Organization in 2001, and peaked in 2007. Then, external demand to GDP shrank afterwards.

Fig 9. External vs Domestic demand (% of GDP)



Source: Bloomberg, CEIC, KBank

Fig 10. China's external demand to GDP



Source: Bloomberg, CEIC, KBank

**What does this mean for central bank policymaking?**

Most EM Asia central banks have signaled increasing concerns on global economic weakness and financial market volatility as a hindrance to exports and economic recovery. The Bank of Thailand (BoT), for example, explicitly stated that THB strength is an obstacle to economic recovery in its monetary policy statement in March. The BoT further talked down the currency by sending dovish signal when it released new economic forecast on March 31st, stating that the BoT could cut rates further if global economy deteriorates. Apart from the BoT, the Monetary Authority of Singapore shifted its stance in October 2015 to ease monetary policy conditions further by reducing the rate of SGD NEER appreciation. Taiwan's central bank also expressed concerns that volatile cross-border capital flows became a destabilizing force to Taiwan's currency. While, the Bank Indonesia took steps to lower its policy rate twice this year to 7.0% as the Fed tightening fear subsided.

Relative policy rates will be the name of the game. Given low oil price and Asia's China-centric trade structure, risks to growth remain on the downside. Countries that are more reliant on external demand, namely Singapore, Malaysia, Thailand, Taiwan, and Korea will face pressure to keep their currencies competitive in order to support exports. And, since exports from Thailand, Korea, and Malaysia are nearly equally as sensitive to world economic growth as to currency competitiveness, these three central banks are likely to follow one another in policymaking. According to Bloomberg survey, more than half of EM Asia central banks are expected to lower rates within the next six months. Against the competitive devaluation backdrop, we believe the BoT will cut rates by 25bps in Q2/16. The key factors to watch are Asian central banks' move and THB NEER going forward.



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