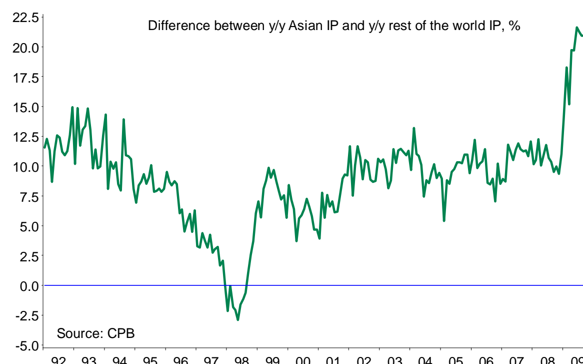
Asia: New World Order

- **Who's riskier? China or Japan? The UK or South Korea? Malaysia or Italy? The Euro-zone or Asia ex-Japan?**
- **Reflecting the two dominant consequences of the global financial crisis so far – the decoupling of Asia and the huge degradation of the West's fiscal position – the answer increasingly may be the old 'developed' economies as historic distinctions blur.**
- **Using GDP weights, we estimate aggregate sovereign CDS spreads for the eurozone, the G3, the G6 and Asia ex-Japan. Asia's spread over the G3 has also compressed to a little more than 30bp and aggregate eurozone CDS has even traded wider than Asia's albeit briefly.**
- **And with concerns over the fiscal position of bigger economies such as the UK, Japan and ultimately the US only likely to build, Asian sovereign risk should continue to outperform.**
- **Looking at their respective fiscal positions of Asia ex-Japan and the G7, these trends are hardly surprising. While Asia ex-Japan's budget deficit this year should be a manageable c.4½% of GDP, it will be approaching 10% of GDP in the G7.**
- **While Asia's public sector debt ratio is a tiny c.35% of GDP, it is on course to breach 90% of GDP in the G7; the level at which the latest academic research finds that longer-term growth performance begins to suffer.**
- **This enormous and rapidly widening gulf in fiscal trends will support and reinforce Asia's continued economic outperformance, not to mention maintaining secular upward pressure on the region's real exchange rate.**

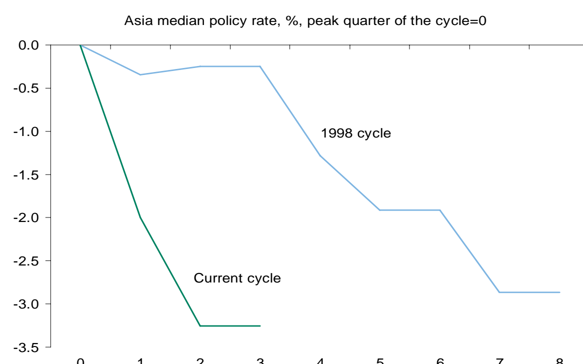
Who's riskier? China or Japan? The UK or South Korea? Malaysia or Italy? The eurozone or Asia? Historically, there has been no question. A defining feature of an emerging market is that they are inherently riskier. But in the new world order that is emerging from the aftermath of the global financial crisis, these distinctions are becoming more blurred. Asia ex-Japan has increasingly 'emerged' while many developed economies look on the brink of submerging under mountains of debt.

Chart 1: Asia Decouples



Source: Reuters EcoWin Pro, BNP Paribas, CPB

Chart 2: Freedom of Manoeuvre



Source: Reuters EcoWin Pro, BNP Paribas

The crisis has produced many results and lessons but perhaps the two most important (at least so far) are the effective de-coupling of Asia and its emergence as the world's key growth engine and, secondly, the enormous fiscal toll that the crisis has exacted on the West. As we have previously written, Asia's de-coupling over the last year flows from the unprecedented aggression of the region's countercyclical strength. Thanks to the external surpluses, huge foreign exchange reserves, increased monetary policy credibility and robust fiscal positions that have been painstakingly built up since the Asia crisis over a decade ago, Asia for the first time was able to act like a 'developed' economy and jam open the monetary and fiscal spigots when the crisis hit.

The contrast with the region's experience in 1998 is stark. Then, fear of capital outflows curbed monetary independence while dire fiscal positions precluded significant fiscal stimulus. For example, nine months

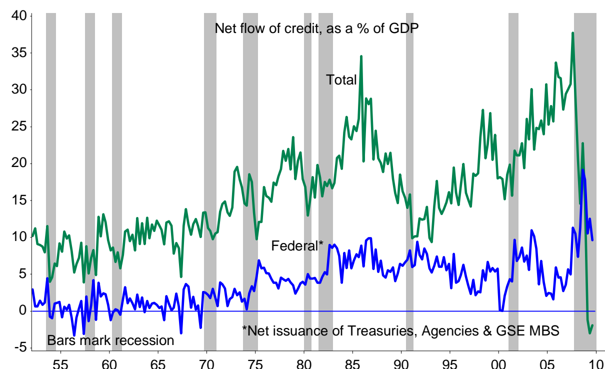
into the Asia, the region's median policy rate had only been reduced by 25bp. This time around, average policy rates were reduced by 350bp in a matter months. And thanks to fundamentally healthy financial system, policy stimulus gained traction quickly, leaving Asia in the vanguard of global recovery. Asia's decoupling is exemplified by the record 20%+ outperformance of its industrial production growth relative to that in the rest of the world. As a result, while the rest of world is labouring with significant spare capacity in both labour and product markets and so lingering deflation risks, Asia is rapidly returning 'to trend' with inflationary pressures now emerging.

The second key result has of the crisis thus far has been the stunning degradation of the West's fiscal position. To escape the worst consequences of savage private sector de-leveraging, governments have effectively swapped private sector debt for public sector debt. In other words, a government borrowing bubble has increasingly replaced the private sector credit bubble as policy makers have had little choice other than to de facto nationalise the flow of credit or see their economies collapse. Tax revenues have also collapsed as bubble-bloated revenues from the property and financial sectors have disappeared, revealing much larger structural holes in fiscal positions than governments were prepared to countenance pre-crisis. As we have previously written, the effective socialisation of credit and corresponding surge in government debt issuance can be seen clearly in the US economy via the Federal Reserve's Z1 Flow of Funds report. Total credit market debt - the unconsolidated debt of the non-financial and financial sectors - shrank in the first nine months of 2009 for the first time since probably the 1930s (Flow of Funds data is only available from the late 1940s).

And the net flow of credit has, of course, turned negative despite huge federal credit creation (issuance of Treasury debt and GSE liabilities) worth 10%+ of GDP (c. USD 1.5 trillion at an annualised rate). Ex-federal flow of credit to the US economy has literally imploded over the last year, slumping by an unprecedented 13% of GDP in the first nine months of 2009 (Chart 4). And with private sector still contracting, nascent recoveries still fragile and political elites under pressure, there is little immediate end in sight to fiscal laxity in the developed world. Just this week, the US announced an expected budget deficit of USD 1.6 trillion for 2010; comfortably above 10% of GDP.

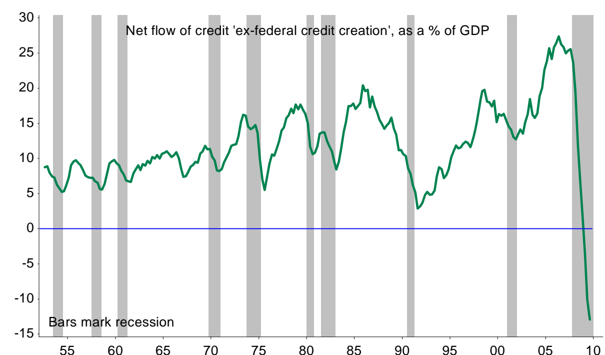
In effect, these two developments underlay the two key tensions that have been roiling global financial markets in early 2010: the scale and timing of policy exit in Asia particularly China and fiscal sustainability

Chart 3: US Nationalisation of Credit



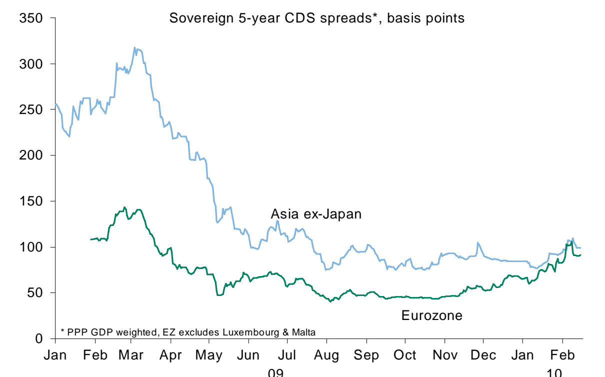
Source: Reuters EcoWin Pro, BNP Paribas

Chart 4: US Private Sector Credit Collapse



Source: Reuters EcoWin Pro, BNP Paribas

Chart 5: Risk Adjustment



Source: Bloomberg, IMF,, BNP Paribas estimates

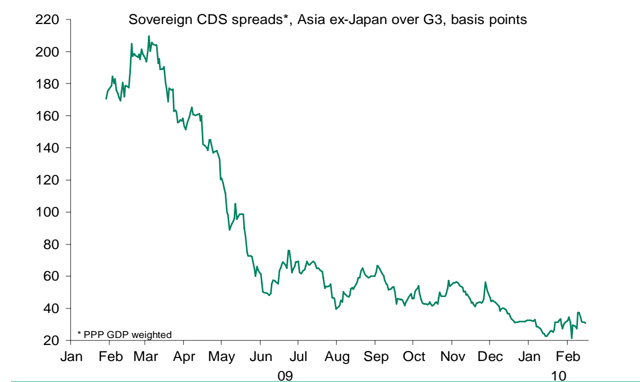
in the West. The nightmare scenario for the global economy would be worst case outcomes for in both cases: an aggressive policy tightening in China that risks a hard landing and a premature fiscal tightening imposed on the developed world by financial markets increasingly and understandably concerned about the alarming trajectory of public sector debt. While we remain relatively sanguine about the risks of the former, the latter is rapidly emerging as the key threat to the global economy.

Fiscal solvency concerns have initially crystallised around Greece, whose c.13% of GDP budget deficit leaves it with no attractive options. Rather like a currency crisis, fiscal crises risk become self-fulfilling prophesies. Financial markets drive up sovereign CDS spreads, which have emerged in recent years as the main vehicle to express sustainability concerns, and, in turn, bond yields (the bond yield can be thought of comprising a real growth and inflation expectation and credit risk captured by the CDS spread). Higher borrowing costs further jeopardise fiscal sustainability (Greek 2-year government bond yields have now soared above German 30-year bund yields) as interest payments spike higher.

Again, as we have seen with currency crises, markets rapidly pursue multiple targets. Concerns over Portugal have flared and Spain is also coming into the spotlight. The stressed euro-zone periphery, which has developed the soubriquet the PIGS (Portugal, Ireland, Greece and Spain) has seen a huge blow out in its CDS spreads. But fiscal problems may be even greater in the much larger UK and Japanese economies despite the extra degree of freedom that free floating currencies provide these two economies. Notably credit agencies have already warned over both economies already this year. Even the US, which as the owner of the world's reserve currency, albeit a bruised one, is most immune to these pressures, has nonetheless also seen its CDS spreads widen sharply as fiscal jitters globally have escalated.

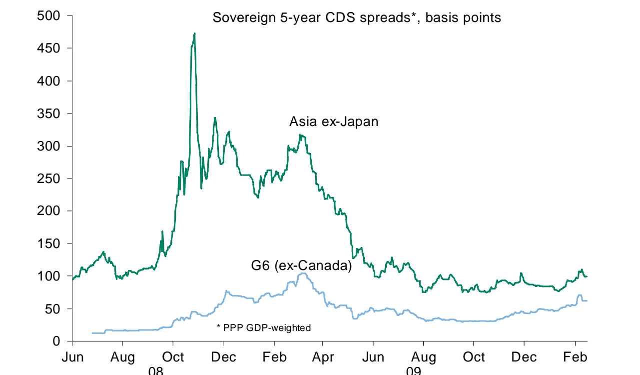
Asian CDS spreads have suffered a degree of contagion. In Pavlovian fashion, markets have marked Asian risk higher as sovereign debt fears in the developed economies have risen. South Korean 5-year CDS spreads have jumped around 25bp for example. But notably Asian CDS has steadily been outperforming that of the West. Using the IMF's GDP weights, we calculate aggregate G3 (US, Eurozone and Japan) and Asia ex-Japan 5-year sovereign CDS spreads. Historically, we estimates that the latest bout of turmoil means that our aggregate Eurozone 5-year CDS briefly traded wider than our Asia ex-Japan estimate (Chart 5)! More generally, Asia CDS spreads have significantly compressed relative to those of the G3 in aggregate; falling to around 30bp by our estimates (Chart 6). Our G3 aggregate is obviously being pushed by the impact of sharply higher CDS spreads in the euro zone periphery. We also therefore calculate a G6 aggregate (so the US, Japan, Germany, France, Italy and the UK) to exclude the impact of these smaller, riskier economies. A similar downtrend is still apparent. After spiking to extreme levels at the height of the global financial crisis in late 2008, Asian risk spreads have steadily compressed vis-à-vis the world's biggest economies and, at around 37bp, are similarly close to record tight levels by our estimates.

Chart 6: Asian CDS Tightens – I



Source: Bloomberg, IMF, BNP Paribas estimates

Chart 7: Asian CDS Tightens – II



Source: Reuters EcoWin Pro, BNP Paribas estimates

This makes sense and, as implied above, there increasingly seems little reason why Asian sovereign risk should be priced higher than that of the West. Why shouldn't Asian CDS spreads moving forward, at least in aggregate terms, trade in line or even through G3 spreads? Certainly, the relative fiscal positions of the respective blocs argue strongly for this eventuality to emerge.

Again using the IMF's GDP weights, we calculate regional fiscal aggregates for Asia ex-Japan and the G7 (as Canadian data is available). We track both deficits and the stock of public sector debt. Both Asia's much more robust pre-crisis fiscal position and its subsequent much less aggressive deterioration in public finances are clear. In aggregate Asia entered the crisis in broad budget balance compared to deficit of around 3% of GDP in the West. The subsequent deterioration of the G7's fiscal position has been breathtaking with the aggregate budget deficit expected to be close to 10% of GDP this year. Asia's fiscal stance has inevitably deteriorated but by much less and the region's aggregate budget deficit

is expected be around 4% of GDP this year; some 5% of GDP better than the G7 (Chart 8).

Ironically, South Korea, which in the initial stages of the crisis was seen as huge sovereign risk and whose CDS spiked north of 600bp, epitomises Asia's fiscal strength relative to the West. The OECD for example estimates that South Korea was running a structural or underlying budget surplus of close to 3% of GDP in 2008 compared to a structural budget deficit of around 3% in the OECD as a whole!

Relative trends in public sector debt are if anything even more propitious for Asia. Asia ex-Japan entered the crisis in 2008 with aggregate public sector debt of a mere 30% of GDP. The stock of public debt in the G7 in 2008 by contrast was almost 40% of GDP higher at close to 70% of GDP. And the pincer movement of falls in nominal GDP and record budget deficits should see G7 debt soar to close to 90% of GDP this year; a rise of almost 20% of GDP in just two years (Chart 9).

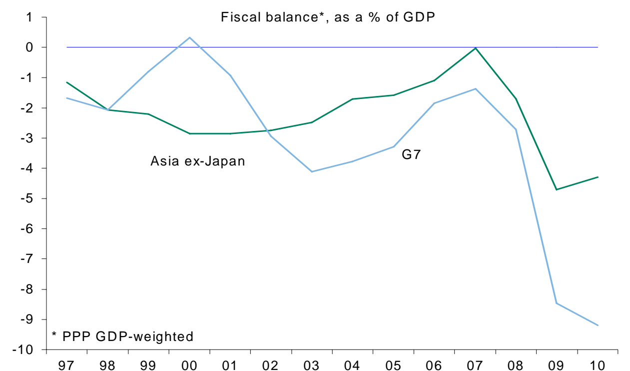
And with fiscal consolidation expected to progress only slowly, debt ratios are expected to keep climbing. Using the Economist Intelligence Unit's (EIU) medium-term projection for public sector debt, we estimate G7 debt should breach 100% of GDP by 2013. The rise in Asia ex-Japan's debt ratio is a mere blip in comparison thanks to the combination of robust nominal GDP growth now returning to the region and of course the much smaller flow into the stock of debt. From its aforementioned low of c.30% of GDP, we estimate that Asia ex-Japan's debt ratio should rise to about 35% of GDP this year and then, again using the EIUs longer-term projections, should flatten out around this level before the drifting lower from 2012 onwards.

Notably, these developments are likely to further re-inforce and entrench the first key outcome of the global financial crisis mentioned earlier: Asia's successful de-coupling and a stepped contribution to global GDP growth. While the developed world one way or another will have to embark upon painful fiscal consolidation in the coming years, generating a powerful headwind for growth, the strength of Asia's underlying fiscal position and robust public sector balance sheets mean that, if global growth falters once again, further significant fiscal stimulus can safely be introduced to sustain economic growth and social stability.

Moreover, recent academic research by Carmen Reinhart and Kenneth Rogoff[1] has shown that for both developed and developing economies there appears to be a tipping point at which public sector indebtedness begins to affect materially the growth potential of economies. Reinhart and Rogoff's threshold: 90% of GDP! Specifically, the authors find that above the 90% threshold, growth in developed economies tends to slide by around 1¼% per annum relative to growth rates in lower debt regimes. Similarly, in emerging economies, Reinhart and Rogoff find that beyond the 90% threshold, GDP growth slows by an average of around 1½% per annum.

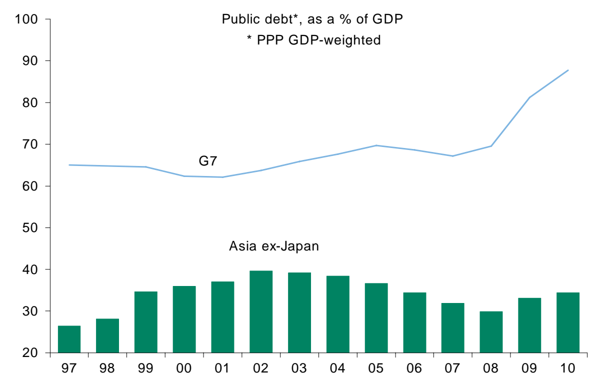
As highlighted above, G7 aggregate debt is expected to breach Reinhart and Rogoff's 90% threshold possibly this year and certainly by 2011. Of course, this aggregate disguises considerable variation across the G7 bloc. Japan is rapidly approaching 200% of GDP debt ratio, having breached the 90% tipping point back in the mid-1990s. Italy has been above it since the 1980s. The two countries that the global financial crisis is propelling through the 90% threshold are France and the UK.

Chart 8: Asia vs. G7 Budget Deficits



Source: Reuters EcoWin Pro, BNP Paribas

Chart 9: Asia vs. G7 Debt Ratios

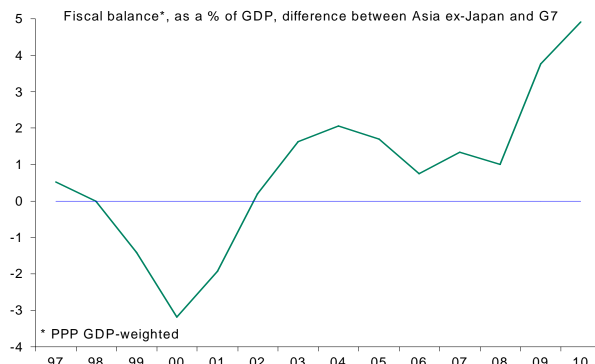


Source: Reuters EcoWin Pro, BNP Paribas

[1] Carmen. M. Reinhart and Kenneth S. Rogoff, 'Growth in a Time of Debt', NBER Working Paper No.15639, January 2010

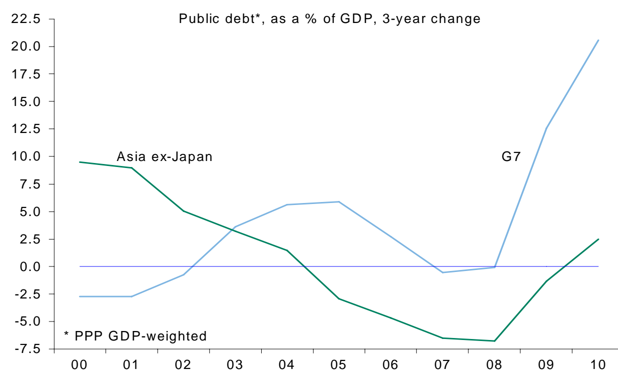
Neither of the two underlying themes currently rocking global financial markets is likely to fade quickly. Given its powerful growth momentum, exceptionally loose financial conditions and emerging inflation pressures, 2010 has to be a year of policy exit in Asia. Ultimately, the evolution of Chinese inflation this year will determine whether a relatively benign normalisation process morphs into the more malign aggressive tightening that de-rails Asia's booming recovery and frothy asset markets. Equally what is clear is that concerns of fiscal solvency in the West are here to stay. What remains unclear is how aggressively markets will impose a near-term and almost certainly premature fiscal adjustment. What is clear is that the unfolding and increasingly self reinforcing logic of the emerging new world economic order means there is increasingly little reason for Asian risk to trade wider than of the developed world. The enormous and rapidly widening gulf in fiscal trends supports Asia's continued economic out performance not to mention sustained upward pressure on the region's real exchange rates.

Chart 10: Relative Fiscal Trends - I



Source: Reuters EcoWin Pro, BNP Paribas

Chart 11: Relative Fiscal Trends - II



Source: Reuters EcoWin Pro, BNP Paribas