

ECONOMIC ANALYSIS

Can Asia avert a 1997-style crisis?

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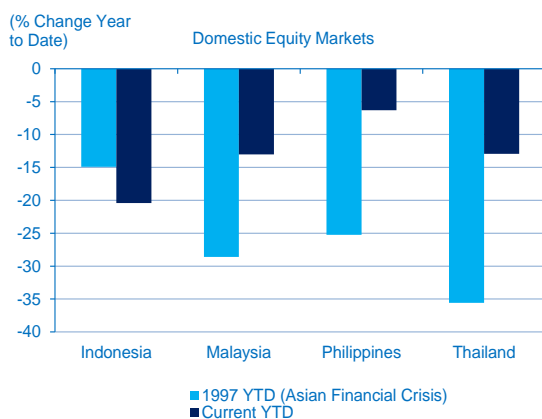
The on-going financial market turmoil affecting East Asian emerging economies, particularly Indonesia and Malaysia, has revived grim memories of the 1997 Asian financial crisis (AFC) amongst investors. The AFC was triggered by macroeconomic imbalances coupled with structural and policy distortions in ASEAN economies. Fragile initial conditions exacerbated the initial financial turmoil, leading to a plunge across asset classes while significantly hurting economic growth. In a symptomatically similar reaction, exchange rates and equity markets have hit multi-year lows across major emerging market economies in East Asia today, dragged by the on-going financial market turmoil triggered by slowing global growth, the imminent Fed rate hike and most importantly concerns over financial fragilities and a sharp real economic slowdown in China (See Figures 1 & 2). In this economic watch, we assess the state of ASEAN economies across two time frames, in 1997, during the Asian Financial Crisis, and in the present context. In particular, we evaluate key structural factors - monetary, fiscal and exchange rate policy stance, political stability, growth inflation dynamics, investment efficiency, external balances, foreign indebtedness, banking system health and liquidity outlook – to ascertain if a repeat of the 1997 Asian Financial Crisis is in the offing for East Asian emerging market economies (EMEs) or is the economic block better placed this time to withstand prevailing macroeconomic and financial challenges.

Throwback to the 90s – Why and how of the Asian Financial Crisis:

The 1997 Asian financial crisis saw a mass exodus of foreign capital from ASEAN economies, which triggered a broad-based currency collapse, a slump in domestic equities and real estate market, a liquidity squeeze and solvency concerns for the domestic banking sector while leaving several domestic companies bankrupt or saddled with a heavy debt overhang. Roots of the crisis can be traced to weak initial conditions, characterized by macroeconomic imbalances, policy distortions and structural issues facing ASEAN economies.

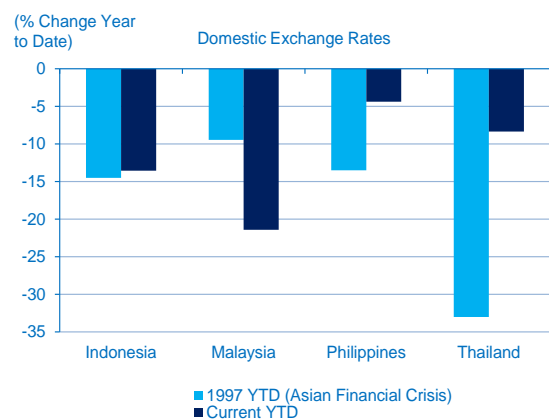
South East Asia’s ‘Moral Hazard’ problem. At heart of the crisis was the ‘moral hazard’ problem in South East Asia, which exacerbated financial vulnerability in the region and magnified the impact of external shocks during the crisis. The moral hazard problem manifested itself across multiple levels. First, the

Figure 1
Equity markets have crash the most in Indonesia



Source: BBVA Research, Haver Analytics

Figure 2
The Malaysian Ringgit has been the hardest hit



Source: BBVA Research, Haver Analytics

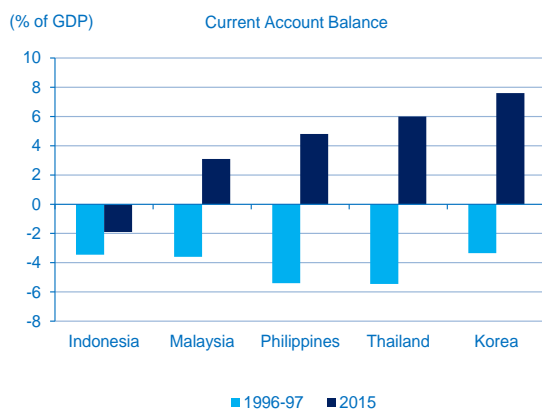
corporate sector where public guarantees to private projects with several instances of favouritism and crony capitalism led to firms overlooking riskiness of underlying investment projects, lax credit risk standards, and a false presumption amongst corporates and investors that most private sector investments were insured by the government against shocks. This led to a foreign debt overhang with underlying investment projects whose returns were substantially inflated. During this time, the Japanese zero interest rate policy aimed at tackling domestic deflation fuelled carry trades, in turn triggering huge capital inflows into ASEAN economies despite incipient signs of weakness in earnings growth and declining profitability for corporates in the region.

Second, a thrust on financial intermediation as domestic banks borrowed heavily from abroad to lend across domestic projects while overlooking their viability. Weak regulatory oversight, lax lending standards, issues of graft, and unhealthy relations between banks and firms led to tainted balance sheets of domestic banks and a rise in non-performing loans. To aid the supply of low cost capital inflows and boost economic growth, policymakers in East Asian EMEs initiated rapid capital account liberalization. Concomitant monetary policy accommodation led to excessive credit growth in the banking system during the pre-crisis years, which translated into a pile up of non-performing loans as banks down played credit risk. Meanwhile, most followed a rigid exchange rate framework, with domestic currencies pegged closely to the US dollar, which helped them keep the risk premium on US dollar denominated debt low.

Third, international banks overlooked prudent risk assessment in their lending to domestic financial institutions. A pile up of short term unhedged foreign currency denominated liabilities jumped manifold for East Asian EMEs. Short term external debt to foreign exchange reserves surpassed 100% for Indonesia and Thailand. As Krugman (1998)¹ noted, ‘to play a game of heads I win, tails the taxpayer loses’ the financial intermediaries in the region played an important role in magnifying domestic financial vulnerabilities and in turn undermined their ability to withstand potential external shocks.

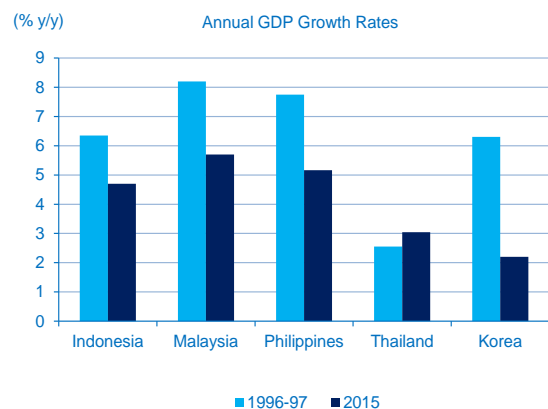
A concomitant economic slowdown in Japan weighed on exports from Asia, in turn worsening trade balances while a sharp appreciation of US dollar against the yen made Asian currencies – which were pegged to the US dollar – uncompetitive. Political instability in key economies such as Indonesia coupled with the lack of structural reforms by domestic authorities and poor banking supervision further undermined investor confidence in the region. Amid heightened macro-instability, in 1997, real estate and equity markets in the region fell sharply, which triggered a contagion. The rapid reversal of foreign capital flows led to a collapse of currencies across the region, starting with the Thai Baht, and spreading on to Philippines, Indonesia, and

Figure 3
Marked improvement in current account balances



Source: BBVA Research, Haver Analytics

Figure 4
GDP growth is visibly slower compared to 1997



Source: BBVA Research, Haver Analytics

¹ Krugman, Paul (1998). “What happened to Asia?”, mimeo, MIT. <http://web.mit.edu/krugman/www/DISINTER.html>

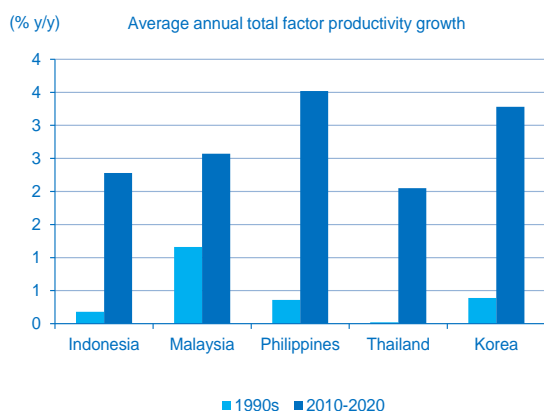
Malaysia, which manifested itself into a broad-based liquidity and solvency crisis with chronic macroeconomic effects. Falling asset prices spiralled into a wave of corporate and banking sector defaults, which led to asset price deflation and undermined government's ability to provide explicit guarantees, in turn triggering a vicious cycle of default, debt and depression.

Drawing a parallel between 1997 and 2015 – Assessing key factors:

Sustainability of current account balances – Focus on quality of improvement. During the early 1990s East Asian EMEs which allowed their current account deficits to balloon in excess of 3% worsened their ability to withstand rapid capital reversals and exacerbated devaluation expectations. In 1997, sharp currency depreciation pressures against the US dollar were seen across economies with high current account deficits such as Indonesia, Malaysia, Philippines, Thailand and Korea while others such as China, Hong Kong, Singapore and Taiwan saw relatively muted currency declines given their smaller deficits or surpluses. Reassuringly, we see a meaningful improvement in current account balances of the former economies in 2015. (See Figure - 3).

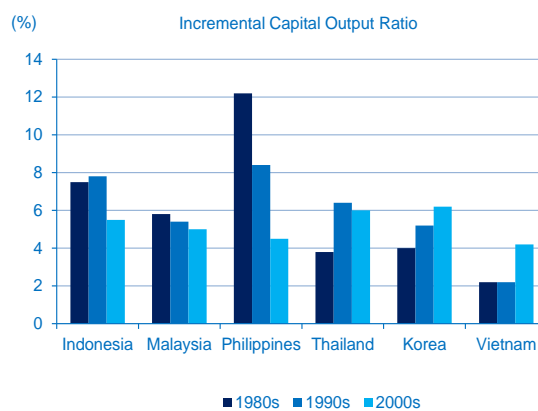
That said, the notion of a sustainable level of current account deficit, i.e. an economy's ability to service its foreign debt (solvency) can vary across economies and time period; and depends on a host of factors such as the stability of the foreign debt to GDP ratio over the long run, the rate and nature of economic growth, which can explain whether the fall in savings is transitory or permanent, and the level of investment efficiency as measured by the incremental capital output ratio (ICOR). Ironically, mid 1990s saw robust GDP growth rates for most East Asian economies, averaging above 6% y/y (See Figure - 4). In contrast, these economies are growing at a much slower pace this year at an average 4% y/y. The reason as noted by Krugman (1994)² was that the contribution of total factor productivity (TFP) to output growth was low in Asia during early 1990s with GDP growth largely fuelled by a pick-up in availability of inputs and rising speculative capital inflows. Thus high expectations and excessive optimism about long run output growth, which further drove rapid foreign capital inflows into the region, were unrealistic and unsustainable. Jungsoo Park from ADB (2010)³ estimates that average annual TFP growth for the Asian economies under consideration has increased from 0.43% y/y during 1990s to 2.7% post 2010 (See Figure – 5). In this context, despite slower pace of GDP growth, the higher contribution of TFP makes output growth across ASEAN economies more sustainable in the present context compared to the 1990s Asian financial crisis period.

Figure 5
TFP levels have improved for East Asian EMs



Source: ADB BBVA Research

Figure 6
Investment efficiency levels need to improve



Source: IMF, BBVA Research

² Krugman, Paul (1994). "The myth of Asia's miracle." Foreign Affairs, November/December

³ Park, Jungsoo (2010). "Projection of long term factor productivity growth for 12 Asian economies." ADB

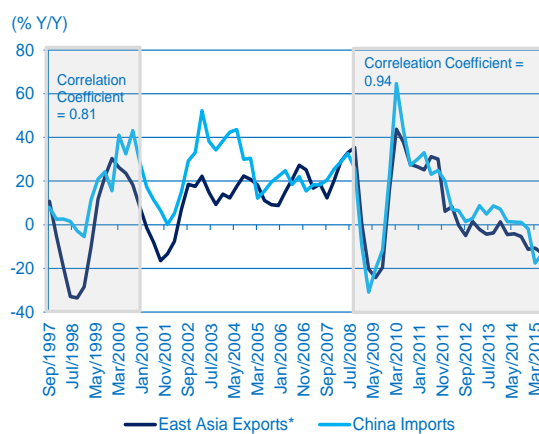
Interestingly, investment rates in 1997 were above 30% of GDP for all economies in the region except Philippines (24%). However, bulk of these investments represented unproductive capital accumulation. In the run up to the Asian Financial Crisis, between 1990 to 1997, Incremental Capital Output Ratios – a crude measure of productivity – had risen in several East Asian countries such as Indonesia, Malaysia, Thailand and Korea, which indicated declines in the efficiency of investment. Comparing with recent estimates of ICOR by the IMF (See Figure – 6), Indonesia, Philippines and Malaysia have seen increase in the efficiency of resource use; while efficiency levels have declined in Thailand, Vietnam and Korea. The rise in ICOR levels in Vietnam and Korea over recent years can be partly attributed to the shift in production structure to higher capital intensity, a common feature of industrialization.

Economic reform efforts in East Asian economies post the Asian Financial Crisis have enhanced productivity, strengthened the business climate and raised the contribution of external demand to growth by increasing competitiveness. Nevertheless, productivity gains have been uneven across the region and less than optimal. As per international experience, the best ICORs achieved for any sustained period are in the range of 3.5 to 3.6 (Rakesh Mohan, IMF 2015⁴). In this context, ICOR levels in East Asia still need to improve, which warrants authorities to expedite structural reforms and address infrastructural shortages.

The risky ‘C’ombination: Commodity slowdown + China tantrum = Contraction in exports.

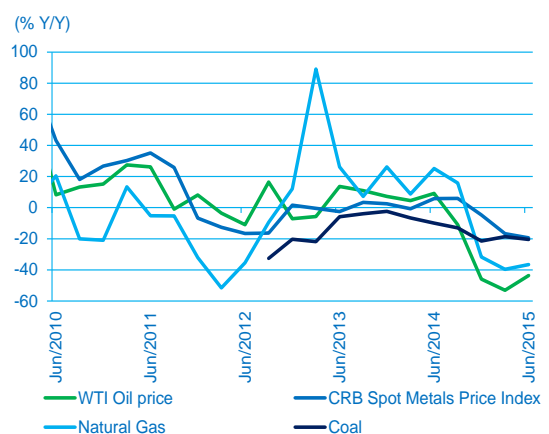
Greater export orientation enhances an economy’s ability to service its debt by generating higher foreign currency receipts. On the flipside, however, it also makes the economy more vulnerable to a slowdown in its trading partners, deceleration in global growth, and other external shocks such as restrictive trade policies in foreign countries and geopolitical risks. Trade openness across East Asian economies was already significantly high in 1997. Measured as the share of exports and imports as a % of GDP, Malaysia’s trade openness was the highest in the region at 94%, followed by Philippines (54%), Thailand (47%) and Indonesia (28%). While these economies still remain highly open, their export dependence on China has increased considerably over the past decade compared to the early 1990s (See Figure – 7). Closer trade links to China makes East Asian economies a lot more vulnerable to a sharp slowdown in the Chinese economy. 23% of Philippines exports are to China, which this figure stands at roughly 12% each for Indonesia, Malaysia, Thailand and Vietnam. Beyond China, bulk of the exports for East Asian emerging economies is intra-regional. For instance, key export destinations of Indonesia are Japan (13% of exports),

Figure 7
Slowdown in commodity prices and Chinese growth have hurt exports of east Asian EMEs



*Includes Indonesia, Malaysia, Philippines and Thailand
Source: BBVA Research, Haver Analytics

Figure 8
Slump in commodity prices has hit export realizations of Indonesia and Malaysia



Source: BBVA Research, Haver Analytics

⁴ <https://www.imf.org/external/pubs/ft/wp/2015/wp1553.pdf>

China (10%), Singapore (9.5%) and the US (9.4%).

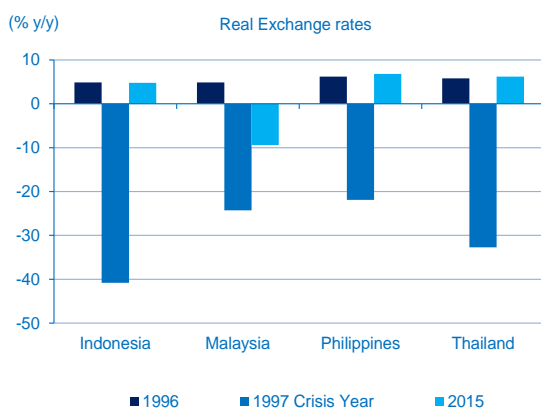
In addition, a huge negative terms of trade shock has also hit economies in the region today through the slump in commodity prices including crude oil, coal, iron ore, rubber, and palm oil, which has hit trade realizations (See Figure – 8). Compared to the 1997 crisis, trade gains have eluded East Asian economies for a lot longer in the present context, with a painful protracted slowdown in exports since 2010. Malaysia is a significant exporter of crude oil, LNG and crude palm oil while Indonesia is a major exporter of coal, refined petroleum, rubber and palm oil. Nearly 30% of Malaysian government taxes come from state owned oil companies. High budgetary exposure to commodity price swings make Major East Asian emerging economies such as Indonesia and Malaysia highly vulnerable to terms of trade shocks.

Exchange rate frameworks are no longer rigid, willing to bend but won't break. A rigid exchange rate policy pegged against the US dollar was one of the key contributing factors towards destabilizing macro balances in East Asian economies during the early 1990s. The Thai baht and Philippines peso were effectively fixed to the US dollar; Indonesia followed a real exchange rate targeting policy while the Malaysian ringgit moved in a 10% range to the US dollar. The policy of effective peg against US dollar was followed by East Asian countries so as to enable external financing of domestic projects through lower borrowing costs and a reduction in currency risk premium. However, the US dollar appreciated sharply in the run up to the Asian financial crisis – the yen/dollar appreciated 56% between spring of 1995 and summer of 1997, in turn leading to sharp real appreciation of East Asian currencies.

From a longer time frame since 1990 to end 1996, the real appreciation was much sharper at 23% in Philippines, 19% in Malaysia, 12% in Thailand and 8% in Indonesia. The misaligned exchange rates led to a loss of trade competitiveness in the region, aggravated current account imbalances and heightened pressure on policymakers to maintain currency stability; and ultimately leading to a collapse in currencies (See Figure – 9). Unlike 1997, emerging Asian economies have today adopted a managed float of its currency, which accords greater independence to monetary policy in achieving price stability and sustainable growth. The flexible exchange rate would continue to help cushion vulnerability of these economies to external shocks leading to shifts in investor sentiments.

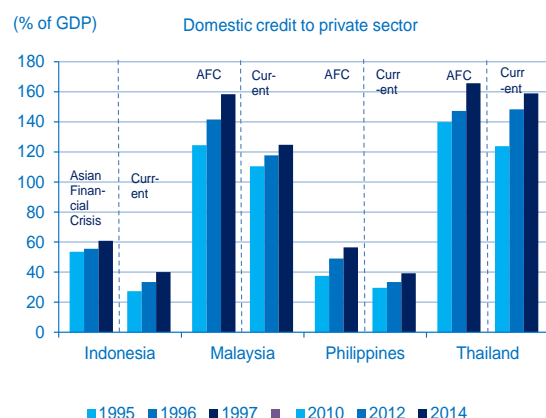
Political stability – grey areas persist. An uncertain political environment in most regional economies aggravated the 1997 Asian financial crisis as it fueled larger budget deficits, and undermined investor confidence over sound policy measures to stem capital outflows. Thailand suffered a government collapse;

Figure 9
Flexible exchange rate frameworks help cushion vulnerability to external shocks



Source: BBVA Research, Haver Analytics

Figure 10
Credit boom in east Asia over recent years is akin to the one seen in the run up to 1997 crisis



Source: BBVA Research, Haver Analytics

Indonesia saw heightened political tensions over the health of President Suharto, policy reversals and national elections, Malaysian Prime Minister accused international investors as being rogue speculators and morons while Korea was on the verge of labor unrest. The fragile political situation, the lack of willingness to implement policy reforms and ignorance over IMF recommendations led to severe deterioration of economic conditions in economies such as Indonesia. The new government in Thailand, however, did show commitment to reforms, which helped stabilize the baht. In the current context, East Asian economies are backed by relatively stable political regimes, which have shown commitment towards implementing structural reforms, although risks to political stability still remain a concern for foreign investors.

Reassuringly for Indonesia, unlike policy inaction on reforms during 1997, the current government led by President Joko Widodo has focused on greater regulatory oversight, institutional and investment reforms and removing administrative bottlenecks to private investments. Philippines too has seen a stable political environment under the Aquino administration, although with next presidential elections scheduled for May 2016 and recent corruption scandals adversely affecting the ruling party's popularity, political uncertainty may become an issue in the medium term. Meanwhile, despite a political coup last year with the military seizing power, Thailand's political stability has visibly improved although not out of the woods. While democratic elections are likely by end-2016, companies have shown respite over the junta's ability to maintain peace over the past year. However, lingering political uncertainty has dampened investor confidence in Thailand with foreign firms putting new investment plans on hold while also weighing on consumer sentiment and public spending on infrastructure development. In Malaysia, political stability has taken a big jolt following graft allegations raised on current Prime Minister and the sudden removal of deputy Prime Minister last July followed by a cabinet reshuffle. Growing political risks in Malaysia, which, investors fear, is sliding into authoritarianism, has hampered the investment climate and dampened consumer and business sentiment, in turn weighing on economic growth.

Financial stability – Do disruptive moral hazard incentives still exist? Rapid financial liberalization provided domestic banks, which included weak undercapitalized banks, with a lot more latitude to borrow from abroad. In light of implicit bail out guarantee by the government, the banking and financial

Table- 1
Debt pileup in emerging East Asian economies is a concern

| Change in Debt to GDP ratio : 2007 to 2014 across Asia | | | | | |
|--|--------------------------------------|---|------------|-----------|-----------|
| | Current total Debt to GDP ratio* (%) | Real Economy Debt Change, 2007 - 2014 (percentage points) | | | |
| | | Total | Government | Corporate | Household |
| China | 217 | 83 | 13 | 52 | 18 |
| India | 120 | 0 | -5 | 6 | -1 |
| Indonesia | 88 | 18 | -5 | 17 | 6 |
| Korea | 231 | 46 | 15 | 19 | 12 |
| Malaysia | 222 | 49 | 17 | 16 | 16 |
| Philippines | 116 | 4 | -3 | 9 | -2 |
| Singapore | 382 | 46 | 15 | 19 | 12 |
| Thailand | 187 | 43 | 11 | 6 | 26 |
| Japan | 400 | 64 | 63 | 2 | -1 |

Source: IMF, BIS, Haver Analytics, Mckinsey Global Institute Analysis, BBVA Research

* Total debt includes government, corporate and household debt

| | |
|-------------|---------------|
| <= Leverage | <= Deleverage |
|-------------|---------------|

Source: IMF, BIS, Haver Analytics, Mckinsey Global Institute Analysis, BBVA Research

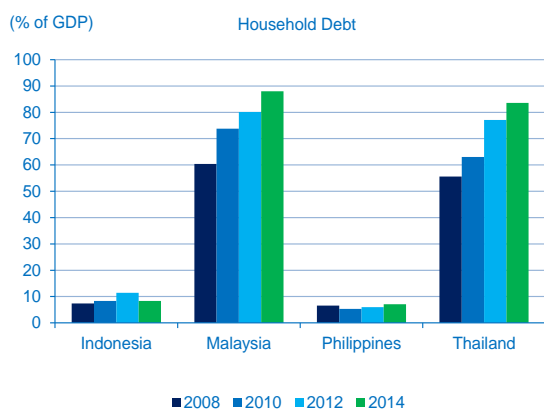
sector, involving non-bank financial intermediaries, was driven by moral hazard incentives which led to excessive and more often reckless lending and bank credit, particularly to the real estate sector. In 1997, the lending boom was biggest in Malaysia (158% of GDP) and Thailand (166%), while more modest, but still rising, in Indonesia (61%) and Philippines (57%) (See Figure - 10). The past five years since the 2009 crisis have seen a similar sharp pick up in credit growth across the region fueled by excessive global liquidity given the extraordinary accommodative monetary conditions across the globe. In level terms, the magnitude of private sector debt may still be lower today compared to the 1997 crisis, but it is alarming nevertheless, particularly for Thailand and Malaysia (See Table – 1). In Thailand, the debt pile up is much higher than what the banks finance, given that non-banks (finance and securities companies) account for a significant 75% of loans to households. Malaysia and Thailand suffer from very high levels of household debt, to which the domestic banking sector is heavily exposed (See Figure – 11). In Malaysia, the surge in debt has been mainly fueled by rising property prices, while in Thailand retail lending by banks and non-banks and profligate fiscal policies such as subsidies for first car purchases are responsible for the debt overhang.

However, we believe that high levels of household debt still poses limited risk to domestic macro stability in Malaysia and Thailand. Household income growth has lagged behind growth in property prices, but not much in a relative sense. Property affordability (house prices to income ratio) is 5 times in Thailand and 4 times in Malaysia, which is much lower than 12 times in Singapore, 16 times in Hong Kong and 8 times in China. In this context, potential increase in interest rates, in light of imminent Fed rate normalization, is expected to a limited impact on disposable income of households, especially so given that Malaysia and Thailand have relatively high per capita GDP levels of USD 10792 and USD 5863 respectively.

Furthermore, the quality of lending, as characterized by bank asset quality levels or Non-Performing Loans, has improved significantly since the pre-1997 crisis levels for most ASEAN economies (NPLs shot above 45% in Indonesia in 1998) thanks to tighter bank lending standards and greater regulatory oversight (See Figure - 12). An exception, however, is Vietnam, whose banking system is currently struggling with higher credit costs and deterioration in asset quality, led by a challenging operating environment. Sluggish domestic demand, tepid recovery in real estate prices from the 2008 crash and heavy reliance on collateral based lending has led to a sharp decline in bank profitability (RoAs lowest in the region at 0.9%) and high levels of NPLs at 3.6% currently.

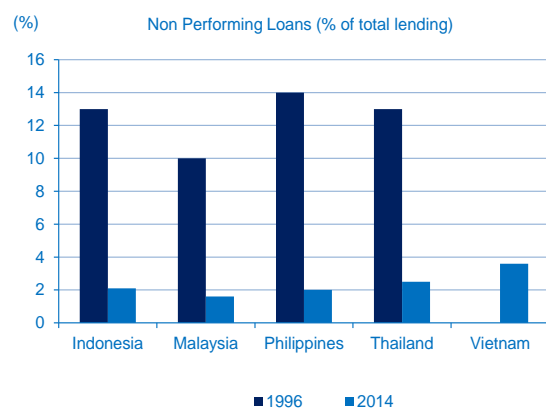
That said, at current levels, NPLs across banks in ASEAN are broadly manageable, particularly so given that banks have adequate capital buffers with Tier 1 capital ratios of 8% to 14% (compared to an average 6% in

Figure 11
Household debt has surged to record high levels in Malaysia and Thailand



Source: BBVA Research, Haver Analytics

Figure 12
Bank asset quality has improved meaningfully, but Vietnam banking sector outlook is concerning



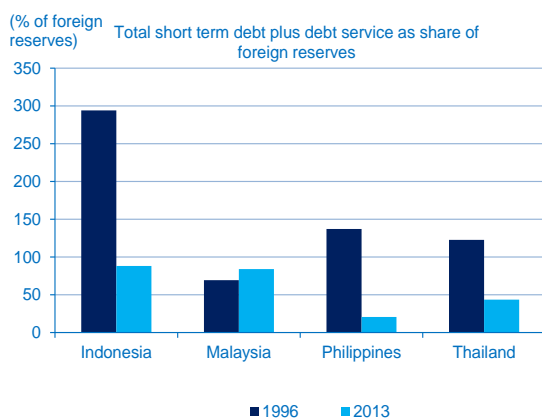
Source: BBVA Research, World Bank, BIS

1997), which is comfortably above the minimum regulatory requirements. Also, unlike governments in advanced economies such as Europe (e.g. the European Union Bank Recovery and Resolution directive that limits government support to failing banks), ASEAN governments have been highly supportive of their banking system in general with bank bail-out still considered as an acceptable solution by most. All in all, the general backdrop of low levels of NPLs, sound liquidity, prudent banking supervision, high compliance enforcement, and largely conservative financial policies lends credence to the credit quality of East Asian EMEs banks in the current challenging environment.

Foreign debt, reserves and capital flows – Visible but patchy progress. We assess whether ASEAN economies have sufficient foreign exchange reserves to cover their debt service obligations and the rollover of short term debt in the event of a liquidity crisis. Since 1997, the debt roll-over risk as measured by the ratio of debt service (interest payments plus renewal of loans coming to maturity) plus short term debt to foreign exchange reserves, has improved for all economies in ASEAN except Malaysia (See Figure - 13). That said, for Indonesia, despite significant improvement, the ratio still remains relatively high at 88.2 (highest in the region), when compared to its peers such as the Philippines (20.6 vs. 137 in 1997) and Thailand (43.5 vs. 123). Meanwhile, for Malaysia, debt rollover risk has increased from 69 in 1996 to 84.1 in 2013. Furthermore, short term external debt as a share of FX reserves has worsened (86.4% in 2015) for Malaysia since the QE taper tantrum in May 2013, while the ratio has improved for Indonesia (41%), Thailand (38%) and Philippines (23%) (See Table - 2). Given Indonesia's and Malaysia's their significant foreign ownership of local currency government bonds highest in the region at 38% and 32% respectively, asset markets, particularly currencies, in the two economies continue to remain highly vulnerable to foreign capital outflows. Malaysia's foreign exchange reserves have fallen to their lowest level since September 2009 with the FX reserves to import cover ratio declining to 7.5 from 7.9 in February, although still comfortably above international standards of reserve adequacy at three months of imports.

That said, from an overall macro and financial stability perspective, Malaysia looks relatively better placed to withstand capital flight compared to Indonesia despite the former experiencing sharper currency depreciation in recent months - the Malaysian ringgit losing more than 16% against the US dollar this year. Key factors mitigating external vulnerability risks for Malaysia include improving fiscal finances, relatively strong GDP growth and low inflation volatility, and a current account surplus. In addition, banking system liquidity conditions in Malaysia remain sound with no major refinancing requirement for blue chip companies through 2016 and a deep domestic capital market supports local funding requirements. On the other hand, Indonesia's current account deficit remains the highest in the region and is likely to persist, while GDP

Figure 13
Debt rollover risk is highest for Indonesia despite significant improvement since 1997



Source: BBVA Research, World Bank Database

Table 2
External vulnerability indicators have improved, for most East Asian EMEs since QE taper tantrum

| | Fiscal Sustainability Central Govt Debt (% of GDP) | | External Sustainability Current Account Balance (% of GDP) | | Liquidity Management Short Term External Debt as share of FX Reserves (%) | |
|-------------|--|---------|---|---------|---|---------|
| | May 2013 | Current | May 2013 | Current | May 2013 | Current |
| India | 46.8 | 43.7 | -4.3 | -1.0 | 33.6 | 23.8 |
| Indonesia | 22.7 | 27.1 | -4.2 | -1.8 | 49.0 | 41.0 |
| Philippines | 47.8 | 47.6 | 4.3 | 5.4 | 23.2 | 23.1 |
| Thailand | 28.7 | 30.9 | -3.2 | 6.0 | 38.6 | 38.1 |
| Malaysia | 54.7 | 52.1 | 1.7 | 2.6 | 71.5 | 86.4 |

Source: BBVA Research, Haver Analytics

growth has hit a six year low and inflation remains elevated and volatile. Progress on structural reforms by the new administration has been slower than expected and issues such as inability to fast-track productive public spending, poor infrastructure, weak governance, red tape and a narrow tax base continues to undermine macro stability in Indonesia.

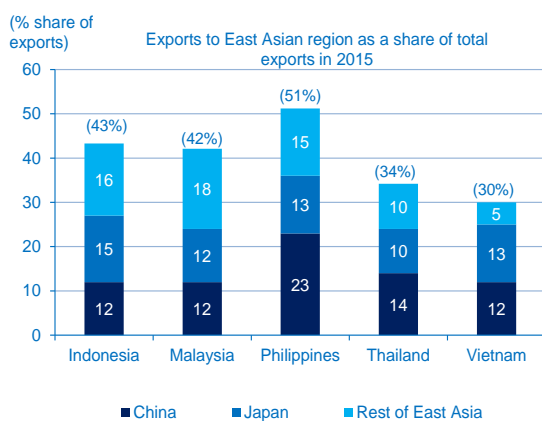
Have East Asian EMEs learnt their lessons from the 1997 crisis? Yes, but not all boxes have been checked

On-going global economic turbulence affecting East Asian economies depicts peculiar similarities to the mid-1990s in terms of external shocks. A less protracted yet significant slowdown in export growth was seen in 1997 for the region weighed by stagnation in the Japanese economy. Japan's growth slowdown was exacerbated by a consumption tax hike in 1997, and a slump in demand for semi-conductors hit East Asian EMEs. The devaluation of the Chinese Yuan in 1994 added to competitiveness pressure on regional currencies while in mid-1997 expectations of a US monetary policy tightening further unnerved investor confidence across the region.

The key exception, however, between the 1997 Asian crisis period and the present situation is the ongoing slowdown in China's growth and the sharp slump in commodity prices – Oil prices fell 31% y/y in 1998 but rebounded in 1999 – which makes the present backdrop more challenging for East Asian EMEs from a medium to longer term perspective. Unwinding of the global commodity super cycle combined with a visible slowdown of China's economy has led to adverse terms of trade for emerging markets in East Asia. The major East Asian tigers, particularly Indonesia, have long thrived on robust gains from raw commodity exports that were used to fund domestic demand. However, China's economy is currently undergoing a structural transformation, rebalancing itself an investment driven towards a more consumption driven economy and its industry focus shifts towards higher technology rather than heavy and polluting sectors. Unlike in early 1990s, when China was still a relatively closed economy, it's today much more deeply integrated with the global economy; and contributes over one-third of annual global GDP growth. Being the world's commodity powerhouse and a predominant player in global supply chain, China's transformation process, characterized by growing consumerism and aided by financial liberalization, would deeply impact East Asian EMEs through trade, financial linkages, and liquidity channels (See Figure – 14).

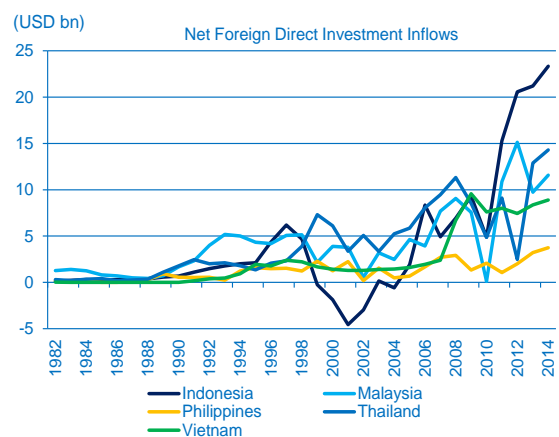
So are East Asian EMEs better placed to withstand the ongoing financial and macro-economic turbulence compared to 1997? We believe they have learnt their lessons and subsequent actions across economic and

Figure 14
Bulk of exports from East Asian EMEs goes to Asia, especially China and Japan



Source: BBVA Research, Haver Analytics

Figure 15
Foreign direct investment inflows have picked up significantly for East Asian EMEs since 1997



Source: BBVA Research, Haver Analytics

political front over the past two decades are encouraging in general. However, governments' in these economies still need to plug key economic gaps. The double blow from China and commodity price slump makes it imperative that East Asian EMEs develop alternative growth engines to boost productivity and competitiveness of non-commodity sector and strengthen regulatory and institutional frameworks. Additionally, reform momentum needs to be stepped up to achieve higher and sustainable growth. Chiefly this includes 1) infrastructure development, 2) make labor laws more flexible, 3) expedite land acquisition process, 4) ease process to secure business permits, 5) tackle governance issues and bureaucratic obstacles, 6) improve education attainment levels and boost investments in R&D, and 7) enhance competitiveness of manufacturing sector.

The spillover effects on East Asian EMEs from a spike in global financial market volatility are inevitable going forward given the disruptive effects of China's economic transformation, US monetary tightening, lingering geopolitical risks and commodity currency interplay. Its impact across the region is likely to be disparate depending on respective state of economic fundamentals, depth of external linkages and domestic policy frameworks. As a group, these economies have seen a surge in long term foreign direct investments over the past decade (See Figure - 15), which echoes rising confidence of strategic investors, who look beyond shorter term shocks that trigger speculative capital outflows, while playing a key role in upholding the economy's credit profile during times of extreme stress.

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