Asia FX: What if China Tanks?

In this report, we would like to explore the impact of China’s hard landing on ASEAN and Japan. A China hard landing scenario of 3-4% below baseline assumes a manufacturing sector in contraction that has spillover effects on the services sector. This also assumes failure of supply side reforms to take flight, a surge in NPL and therefore, corporate debt defaults in mainland China, contractions in imports, domestic consumption and investment, a significant drawdown of its forex reserves, reinstatement of capital controls and therefore, a reversion to a pegged CNY to USD at USD7.5-USD8.0.

There are different channels of impact on ASEAN and Japan namely: trade linkages, output effect, price effect, credit markets, equity markets, monetary actions and reactions in the region and ripples via the yuan volatilities up to the point that it is re-pegged to the USD and capital controls are reinstated.

According to our regression findings, the currencies most affected recently by CNY fluctuations include SGD and JPY. The rest of the currencies have had lesser impact from CNY. Perhaps the most interesting finding is the fact that IDR could benefit from CNY depreciation.

China’s Impact on the World

The start of 2016 was not a quiet one. The sell-off in A-shares and the Renminbi had sent ripples of shocks across the globe. Pressure points in the Shanghai Comp, CSI 300 clearly aligned with those of other benchmark indices. The rally in USDCNH and USDCNY also lifted many USDAXJs. This raises fresh concerns on how a sharp deterioration in the Chinese economy could impact regional peers. In this report, we would like to explore the impact of China’s hard landing on ASEAN and Japan should it occur.

What does a hard landing in China entail?

A hard landing scenario for China is first defined by a real annual growth of 3-4% below our baseline scenario 6.6% this year. This assumes a manufacturing sector in contraction that has spillover effects on the services sector. This also assumes failure of supply side reforms to take flight, a surge in NPL and therefore, corporate debt defaults in mainland China, contractions in imports, domestic consumption and investment, a significant drawdown of its forex reserves, reinstatement of capital controls and a reversion to a pegged CNY to USD at USD7.5-USD8.0. This scenario discounts the
fact that there could be political and social instability should a hard landing occur. Whilst this is not our baseline, for the purpose of context and simplicity in our report, we assume this scenario to start unfolding in the second half of 2016.

What Does It Mean For ASEAN & Japan?

A China hard landing will not bode well for ASEAN given their trade, tourism and financial links. However, the impact is likely to differ depending on how strong those linkages are. There will be an initial kneejerk response to a hard landing and the imposition of capital controls; but could be short-lived as markets could perceive this as a positive, helping to keep the CNY stable. A China hard landing is likely to spur a flight to safety and safer assets and the JPY will likely be the main beneficiary, climbing higher on such safe-haven flows.

The Ripples

Impact Via its Trade Linkages

China demands a substantial amount of raw materials, intermediate and capital goods for investment from its regional peers. More than 30% of Australia’s exports go to China. For Korea and New Zealand, it’s around 20%. For most of Asia including Japan, Malaysia, Indonesia, Thailand, Singapore and Philippines, the figure is around 10%. The impact of China’s slower growth has already been felt in the region, reflected in the deceleration and even contractionary export growth numbers in the region. Profits of exporting companies are dampened as a result.

Chart 1: Exports to China as % of total exports

More importantly, ASEAN economies that are export-oriented would probably bear the brunt in via channel, Singapore, Malaysia and Thailand. Indonesia is likely to be the least affected by the trade links with exports to China accounting for just 10% of total exports. Japan, whose exports to China account for 17.5% of total exports (down from 18.3% in 2014), is also likely to be impacted negatively

Impact Via The Output Effect

A worst case scenario for China could see persistent contractions of the manufacturing and construction sectors to see no wage growth and greater unemployment which could in turn affect domestic consumption and the
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services sector. China imports a fair bit of services through tourism. Those countries that have benefitted from Chinese tourists will see their retail and hospitality industries hit should tourists arrival slow.

Impact Via The Price Effect - Including Commodity Slump

The producer price index has been falling since 1Q of 2012 and China has been exporting the steel that its domestic economy has excess of. China accounted for around 50% of world steel production in 2013. The over production capacity as well as slower manufacturing and construction activities contributed to sluggish base metal prices, affecting the commodity proxies. This assumes the failure of the supply side structural reforms to take flight or at least they would not be able to take effect in time before sharp deterioration in the industrial output.

As for ASEAN, the drop in demand for commodities like coal, base metals, agro-products are likely to push down prices. The fall in these commodity prices, exacerbated by slumping oil prices as a result of glut in supply, will impact commodity-exporting economies likely Malaysia and Indonesia hard.

Impact Via The Credit Markets

A key risk in the medium term is the highly leveraged corporate sector and this could potentially be systemic if a significant number of large corporations start to default on their debts, leading to a spike in NPLs, credit risk premium and a potential credit crunch. That could exacerbate cash flow problems, impact corporate earnings and employment.

A credit crisis in mainland China could trigger similar concerns in ASEAN corporates, leading to portfolio outflows. According to our rolling correlation between the CNY and the ASEAN economies (see table below), credit markets in Philippines and Thailand could be most vulnerable to a credit crisis in China. The correlations between China's CDS and that of Malaysia and Indonesia have come off recently but both have longer periods of elevation around 0.8 rather than lower.

Chart 2: 30-Day rolling correlation of ASEAN and China CDS

![Chart 2](chart_url)

Source: Bloomberg, Maybank FX Research

However we do not rule out impact on other ASEAN economies. For example, Singapore banks have exposure to companies that are doing business in China, particularly property developers and banks. A credit
crisis in China could trigger a credit squeeze in Singapore, spurring a rise in non-performing loans of Singapore banks’ and corporate defaults.

In addition, Indonesia and Malaysia are also vulnerable to capital flight given the high foreign holdings of government debt. In Malaysia, 31.4% of MGS and GII are held by foreigners while the percentage for Indonesian government debt is around 38.2%. The high foreign holdings of government debt could mean high risks of a portfolio outflow once.

**Impact Via the Equity Markets**

Since the global financial crisis of 2008-2009, the strength of the correlation of equity prices changes between China and other Asia countries. The recent equity rout in China has also demonstrated this fact. Risk-off mood could prompt outflows from the EM equity bourses including that of ASEAN and Japan on fears of a drop in corporate earnings.

The rout is likely to be indiscriminate due to the potential of a global portfolio rebalancing away from emerging Asia as a result of the China trigger.

**Chart 3: Equity Rout Will Be Indiscriminate**

Singapore-listed companies with exposure to China (according to SGX in late Oct 2014, there were around 30 companies with a market cap above SGD250mn that reported more than half their revenue or assets in China in the last financial year) are likely to trigger a sell-off in Singapore equities and outflows out of Singapore. The sell-off could once again see the ASEAN and Japanese equity markets re-enter bear markets.

**Monetary Policy Actions and Reactions in ASEAN and Japan**

Falling global demand led by China is likely to spur policy action in the region.

Singapore could see a re-centring of the policy band lower and likely zero-appreciation stance and possibly widening of the band to allow for greater swings in the FX markets.

Regional central banks are likely to push their policy rates lower to mitigate the drag on their financial systems and economies.

However, some economies like Thailand whose policy rate is already at historic low levels might have to resort to other measures, including...
capital controls, to stem capital flight and maintain stability in their economies and currencies.

Easing monetary policies will add to the sharp downward pressure on regional currencies, particularly the SGD and THB.

**Impact Via Exchange Rate and Reinstatement of Capital Controls**

A sharp deterioration in the fundamentals of China could quickly result in rapid depreciation in offshore yuan. The slide in CNH would have impact on ASEAN currencies. Bear in mind however, a hard landing scenario would suggest that China has already drawn down substantial amount of reserves, perhaps USD 1trn from its current USD3.3 trn with no bottom in sight for the economy. The depreciation bets on the yuan could escalate with the help of speculators and arbitragers. The fact is the forwards yuan market and the CNH markets have become sizeable in terms of depth, variety and liquidity and forwards market and offshore yuan markets could quickly the spur greater weakening in onshore yuan. This scenario could quickly prompt the authorities to peg the USDCNY temporarily.

With the imposition of a USDCNY peg, we also expect the authorities to reinstate capital controls. In fact, the authorities have already stopped approving additional quota for qualified domestic institutional investor (QDII) since Apr 2015. A hard landing scenario could mean that cross-border liquidity management could be tightened and free trade accounts could be frozen. Those free trade accounts were introduced by PBOC to differentiate cross-border transactions carried out in the Shanghai Free Trade Zones from those onshore outside the SFTZ. International businesses may be not be able to repatriate cash back to their home countries for temporarily. If capital outflows were to surge in a disorderly manner with no bottom in sight for the economy, USD1trn FX reserves drawn, drastic capital controls may be in place by end of the year.

A hard landing should cause the USDCNY to spike and lift the USD/ASEANS along with it. However, the imposition of capital controls in China should bring some relief to the USD/ASEANS as it “stabilizes” the CNY, but these currencies should continue to remain heavy on concerns about the Chinese economy. The JPY, however, should stand to benefit from the China hard landing with safe-haven flows lifting the JPY higher against the USD as shown in the recent episode.

**Who will be impacted the most?**

**Chart 3: SGD Is Most Vulnerable To CNY Fluctuations**

![Regression Coefficients (90-days Rolling) With CNY](source: Bloomberg, Maybank FX Research)
According to our regression findings, the currencies most affected recently by CNY fluctuations include SGD and JPY. The rest of the currencies have had lesser impact from CNY. Perhaps the most interesting finding is the fact that IDR could benefit from a CNY depreciation.

### FX Forecasts under Worse Case Scenario

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