May 28, 2020

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The cost of stimulus in ASEAN and India

How rising budget deficits and public debt impact the region

ASEAN and India's governments have unveiled large-scale fiscal stimulus in response to the COVID-19 pandemic. Consequently, fiscal deficits are set to widen, likely leading to higher public debt. While stimulus is needed in times of crisis, the economic consequences of increasing fiscal deficits and public borrowing will be complex, particularly for countries that are highly exposed to foreign capital.

Source: iStock

> "This is not just a public health crisis; it is a crisis that will touch every sector."
>
> Tedros Adhanom Ghebreyesus, WHO Director-General

The economic fallout of COVID-19 is severe

Extended lockdowns and community quarantines in the region have weighed on economic activity substantially. Unlike other crises, in which economic engines, though impaired, were still active, this time we saw a sudden significant slowdown from both the supply and demand sides for roughly two months. This has led to a collapse in private consumption and business investment. Q1 GDP prints for some countries have been negative, and we expect output to plunge even deeper in Q2 followed by a robust rebound in the second half of the year. However, a certain proportion of the output loss will not be fully regained, and we are likely to see some economies such as Singapore, Thailand, Indonesia and the Philippines experience a technical recession this year.

So far, several governments have flagged an easing of restrictions. After all, it is difficult for emerging economies in ASEAN and India to afford prolongated shutdowns. The economic fallout will be especially severe where many people are living below the poverty line and small businesses operate on a thin profit margin. However, given that the infection curves in countries like India, Indonesia and the Philippines have not yet sustainably flattened, risks of a second wave remain elevated. Another episode of exponential infections would be a disaster from both the economic and human perspectives. These governments are walking a tight rope, balancing the trade-off between lives and livelihoods.

Financial indicators show which countries have space for extra debt

Least favourable (red) / Most favourable (green)

% of GDP, otherwise stated

	IMF Fiscal Monitor			Debt Sustainability Indicators			
Country	Cyclically adjusted fiscal balance (% of potential GDP)	Gross public debt position	Net fiscal lending/borrowing position	Short-term external debt (% of total reserves)	Debt service ratio (% of exports)	Non-financial corporations core debt	Households core debt
India	-7.0	71.9	-6.3	26.1	5.8	44.0	12.2
Indonesia	-2.2	30.4	-1.8	39.7	26.0	22.7	17.0
Malaysia	-2.7	57.2	-3.3	94.3	6.6	68.6	68.2
Philippines	-1.9	38.6	-1.6	20.3	6.6	n.a	n.a
Singapore*	1.3	111.8	3.7	n.a	n.a	123.8	51.8
Thailand	-0.7	41.1	0.1	29.3	6.1	46.9	69.2
Vietnam	n.a	42.9	-3.5	35.3	n.a	n.a	n.a

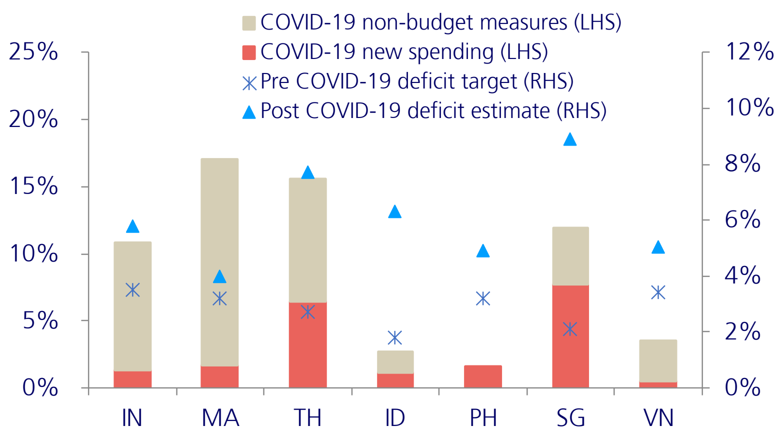
*While Singapore has a high level of gross public debt to GDP, it has a large amount of assets in excess of its liabilities on the balance sheet

Source: ZIG, BIS, latest estimates by IMF, World Bank, ADB and national central banks

Fiscal support to the rescue?

In times of crisis, policy stimulus is key in preventing systemic default. In our recent topical paper (Gloom, but not doom, as recession bites), we have emphasised the importance of policy support in preventing the global economy from falling into a downward spiral.

Budget deficits will widen given tax cuts and higher fiscal spending



Source: ZIG, various government official announcements and estimates.

In the region, national central banks have acted with whatever-it-takes conviction to inject enormous liquidity into the system. Nonetheless, liquidity has a limited impact as households and businesses hesitate to take on extra debt given the prospect of collapsing profitability, job losses and pay cuts. Fiscal stimulus is therefore a more effective measure to provide support. Regional governments have rolled out large-scale stimulus, with headline figures showing a scope of 1% to 17% of GDP although not all packages are as substantial as the headlines suggest.

Despite big headlines, new spending is limited

A closer look at the details reveals what can be considered new spending, which will have the most direct effect. As shown in the chart above, fresh spending in Singapore and Thailand is the largest, accounting for around 6% to 8% of GDP.

In Malaysia, once indirect measures such as subsidised loans from the central bank and reduced employee contributions to compulsory retirement funds are stripped out, effective fiscal spending stands at only about 1.7% of GDP, much smaller than the headline number of 17%.

India has promised a package of 10% of GDP, counting both fiscal and monetary support. However, stimulus measures mainly center around credit guarantees, loans and reductions of social security contributions for employees. That means immediate spending is rather small.

Perhaps not surprisingly, those governments with tight fiscal space are less likely to spend than the others. The table on the first page shows Singapore and Thailand have more leeway compared to their regional peers, based on their net fiscal lending/borrowing positions according to the IMF. That explains why these two countries are the most willing to dig into their pockets.

With fiscal expenditure set to rise and potential shortfalls in revenue resulting from tax cuts and weak economic growth, fiscal deficits are likely to widen from the pre COVID-19 level of around 2.5%-3.5% of GDP to probably 6-9% for India, Singapore, Indonesia and Thailand and 5% for other countries.

Rising fiscal deficits means increasing debt

Indonesia's government has planned to issue around IDR 550tn (3.3% GDP) in sovereign debt and to raise IDR 450tn (2.7% GDP) from 'pandemic bonds. In Thailand, the government intended to obtain an additional THB 1tn (6% GDP) in borrowing. India also announced an INR 4.9tn (2.3% GDP) bond issuance for the first half of its current fiscal year and opened up the bond markets to attract more foreign capital.

We expect government debt to GDP will rise by at least 5ppt, raising the ratio in most countries to around 40-50% of GDP. In Malaysia and India, which both had a higher level of public borrowing pre COVID-19, debt will widen to around 65% and 75% of GDP respectively. Perhaps, Singapore is the only exception as it has sizable fiscal reserves to tap into. Besides, Singapore's system is closer to other developed markets than its regional counterparts.

While financial stability in India remains a concern, emerging economies in ASEAN entered the current crisis with relatively sound balance sheets compared to other emerging markets (EMs). For years, most ASEAN governments have prudently managed their debt and fiscal deficits. As a result, many of them have a sufficient buffer to take on extra debt at this point without increasing their debt to precarious levels.

With respect to financing options, we see three possible sources: the private sector, international institutions such as the IMF, the ADB or the Word Bank, and national central banks. Regarding the first option, raising fund from the private sector is a challenge in times of crisis. Global risk-off sentiment has weighed on foreign investors' appetite for EM bonds, while market dysfunctions and tighten financial conditions also limit the amount of debt a government can acquire in the local market. A more viable option would be to take multilateral and bilateral loans from these institutions and other sponsors. These kinds of loans usually have favourable interest rates and repayment terms. However, it should be noted that these loans are mainly in foreign currencies and might come with some forms of conditionality. The third funding source is national central banks through bond purchase programs in the primary and secondary markets, which we will look into later in this paper.

The consequences of debt and widening fiscal deficits

One immediate consequence of increasing government borrowing and fiscal deficits is a potential downgrade of the sovereign credit rating. In April, credit rating agencies including S&P, Fitch and Moody's revised down their economic outlooks for Malaysia, Indonesia and Thailand, citing increasing budget deficits, higher public borrowing and deteriorating macro conditions.

We believe most governments will attempt to return to the pre-crisis level of fiscal deficits. For countries like India and Malaysia, where debt is already at high levels, returning to lower debt to GDP ratios is particularly important to avoid a downgrade in sovereign ratings. For Indonesia, with high exposures to foreign capital, reducing the amount of external debt makes the country less vulnerable to exchange rate and interest rate shocks down the road.

We see three potential ways for governments to repay their loans: default, outgrowth of debt, or austerity. Default is the most painful way and we do not think the region will take this path. The best way to get out of debt is to outgrow the debt. After all, debt is not a bad thing if it generates higher return through economic growth. However, it is challenging in times of crisis as growth momentum slows significantly. This year, we expect regional output will barely grow, if at all.

It is quite likely that governments will opt for some form of austerity once the crisis is over. Before the crisis, most governments had already adopted a conservative stance regarding their budgets for 2020. Many countries have official limits for budget deficits, which have been relaxed temporarily amid the pandemic.

Austerity means fiscal spending cuts and tax hikes in the future, potentially weighing on growth. That being said, a gradual return to pre-crisis levels of budget deficits is preferable and should proceed only after growth bounces back more sustainably and the private sector regains its strength.

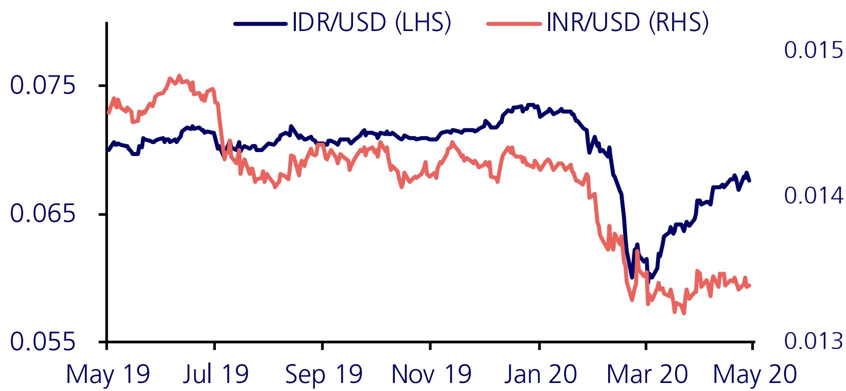
A great experiment for central banks

As mentioned, one of the funding sources for government debt is from national central banks. Some central banks have purchased a sizable portion of government debt in both primary and secondary markets. While most still focus on conventional toolkits, some have started venturing into the territory of unconventional policies including debt monetisation, long-term repo operations (LTROs) and quantitative easing (QE).

Indonesia: not yet on a path to helicopter money

Indonesia's government has revised its law to allow Bank Indonesia (BI) to purchase government bonds directly in the primary market. On April 21, BI made the first purchase of around IDR 1.7tn government bonds in the primary auctions. Regarding this

Large capital outflows weighed heavily on currencies



Source: Bloomberg

development, the credit agency, Fitch, in its statement flagged risks of "increased political interference in monetary policy decision making and erosion of the market's ability to price Indonesian public debt". According to BI, the bank will only act as the last resort when the market cannot absorb all offers by the government. We expect BI will not step too far into the area of debt monetisation as a sustainable way of financing government debt since it will permanently increase the monetary base, ultimately causing inflation down the road.

India: finding an alternative to short-term rate cuts

In India, credit market dysfunction has been an issue since the shadow banking crisis in 2018, and its impaired banking system limits the transmission mechanism of monetary policies. To smooth this out, the Reserve Bank of India (RBI) has experimented with long-term repo operations (LTRO), one of the ECB's tools, to lower funding cost for the term maturity ranging from three months to three years. While this has helped to a certain extent, the latest data show financial conditions remain tight. Banks are reluctant to lend to SMEs as default risks are elevated. Credit spreads of Non-Bank Financial Companies (NBFCs), an important lending source for the private sector, have also risen sharply. Essentially, until the banking system is cleaned up properly, we continue to see a similar situation going forward.

Thailand: will QE be the next move?

Among others, Thailand might be the first country that activates QE as its policy rate is now at a record low of 0.75%, approaching an effective lower bound of 0.25%. The central bank has ramped up its government bond purchases. It also emphasised a willingness to make additional purchases, aimed at lowering the volatility in the government bond yield and facilitating a normally functioning market. One might argue that these purchases were not large and systematic enough to qualify as QE. Yet we find it quite possible that the Bank of Thailand (BoT) is going to move in the direction of QE, especially when its policy rate hits the floor. The central bank has already experimented with other unconventional measures such as the establishment of a THB 400bn Corporate Bond Stabilisation Fund, allowing it to acquire corporate bonds in the primary market and introducing a facility to provide liquidity to mutual funds.

QE in emerging markets is a new phenomenon

It is not easy to predict market reactions and the potential impact of unprecedented large-scale asset purchases in EMs. A potential risk is that excess liquidity might have lasting effects on financial stability and cause asset bubbles on the back of easy money, especially as risk management and governance standards in EMs are still limited.

In fact, financial stability issues are not new in the region. The painful memory of the 1997 Asia Financial Crisis has not yet faded. Thailand, in particular, already had high and rising household debt, accounting for more than 70% of GDP, coupled with the deteriorating credit quality of SME loans since last year. We are therefore concerned that these issues might be amplified on the back of cheap credit.

Another aspect is the potential impact on inflation given a large scale expansionary monetary policy, which might as well affect currency dynamics and capital flows. Given that inflation remains benign in most countries in the region currently, this seems not yet a worry if the implementation of QE is only short-lived.

"Epidemics are a stress test for the system."

Michael J. Ryan, WHO Informal Advisory Group

Mind the pre-existing imbalances

In times of crisis, pre-existing imbalances can cause a disruptive domino effect or act as a hinderance to reduce the effectiveness of policy measures.

In India, the impaired banking system has been a challenge for years. The issue came to the surface in 2018 following the non-bank financial companies (NBFCs) crisis. The most recent crisis of Yes Bank with a large amount of non-performing loans on its balance sheet and high exposures to troubled NBFCs, reveals loopholes in governance standards within the system. The impaired banking and financial sectors prevent the RBI from transmitting its policy rate cuts to households and firms. On top of that, a prolonged economic crisis, which might cause a series of defaults, could evolve into a financial crisis, dragging the economy into a severe and drawn-out recession. For now, we have not yet seen that this is the case in India, but risks remain elevated.

Indonesia is highly exposed to foreign capital. While the central bank is very prudent in ensuring financial stability, the country struggles every time foreign investors take their money out on a large scale. Heavy dependence on foreign capital limits BI from delivering rate cuts. If capital outflows become severe, BI might end up hiking rates at the worst time. While Foreign Direct Investment (FDI) is more durable capital than short-term financial flows, Indonesia attracts limited FDI compared to its regional peers due to its rigid laws and less favourable business environment for foreign investors. In order to change the current dynamics, structural reforms are required.

In the case of Malaysia, the country has the highest level of public debt in ASEAN and is also extremely reliant on foreign capital, perhaps only second to Indonesia, while having a constrained reserve to defend its currency. Malaysia is also vulnerable to oil price shocks as much of its fiscal revenue is drawn from oil and gas income. On the political front, the country has recently gone through unexpected transitions with a new prime minister coming to power. Until the new government has a stronger establishment, political risks persist, weighing on investors' confidence in placing long-term investment in the market.

The way forward...

Undoubtedly, fiscal stimulus is needed to prevent mounting job losses and a free fall in economic output. In our view, regional governments have acted swiftly within their capacity to provide support to households and firms. Meanwhile, national central banks have also lent a helpful hand in ensuring sufficient liquidity supply, defending their currencies amid heavy capital outflows, and facilitating governments' fiscal expansion programs.

Having said that, once the pandemic is over the side effects of higher public debt and fiscal deficits will start to bite. Of course, it also depends on which route governments take to return to their pre-crisis levels of debt and deficits. If not managed well, potential fiscal spending cuts and tax hikes could dampen economic growth for years. The region could then end up being stuck in the middle-income trap for longer.

On the other hand, the crisis is revealing the weakest parts of economies, which require fixing. Structural reforms are needed to provide sustainable solutions for transforming these economies, making them better prepared and more resilient to future downturns. In practice, however, such measures take time and require a strong political will to be effectively implemented.

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