

Asia Focus

Asia: Impact From Euro Area Debt Crisis - Possible Liquidity Dry Up, Or Extended FX Weakness

- *Our call has been that this part of the world will be impacted through the interbank liquidity and credit channels. Recent developments in SGD SOR, and Asian FX weakness clearly reflected this. Another indicator is the Euribor TED spread which signals stresses in the US dollar funding market especially among European banks. So far, the general reading is that we are worse off than the Bear Sterns episode, but not as severe as Lehman's situation in 2008. However, we have to watch developments on this front closely. If liquidity does dry up, the situation in Asia could change materially.*
- *Another channel is extended FX correction leading to an FX crisis. We believe the recent move in the FX market is a currency adjustment rather than a currency crisis in the making. Short-end yields in Asia have not risen significantly but that will be something to watch for signs of greater distress in the coming months.*
- *Since the start of August, Asian currencies have depreciated by around 5% against USD. The comparison drawn against 2008 suggests that there could be more downside to the Asian FX given that the Asian currency index fell around 11% back then. However, we maintain that this is not another FX crisis in the making.*
- *Our calculations indicate that the FX reserves in the emerging Asian countries are significantly higher compared with the foreigners' investments in the country's government bonds and equities (since 2002). From the FX perspective, this is some reassurance that the impact from large outflows from these countries will be manageable.*
- *Asia also stands out in terms of its strong economic fundamentals, including current account surpluses and stronger fiscal positions compared with the troubled West. Asian corporates have cut back on leveraging since the Lehman crisis, thereby increasing their resilience should credit or liquidity conditions weaken.*

Fault Lines In Asia

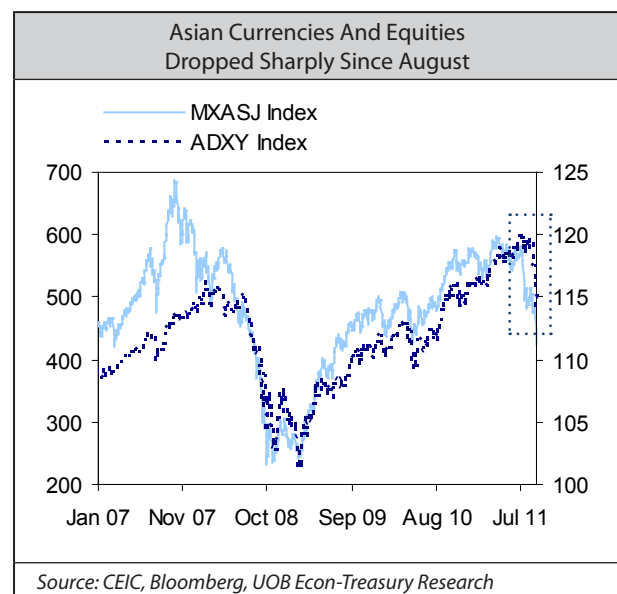
(1) Watch Possible Dry Up Of Liquidity - Worse Than Bear Sterns, But Not Lehman Yet

Our call has been that this part of the world will be impacted through the interbank liquidity and credit channels. Recent developments in SGD SOR, and Asian FX weakness clearly reflected this. Another indicator is the Euribor TED spread which signals stresses in the US dollar funding market especially among European banks. So far, the general reading is that we are worse off than the Bear Sterns episode, but not as severe as Lehman's situation in 2008. However, we have to watch developments on this front closely.

(2) Asian FX Weakness, Leading To Sharp Rise In Overall Cost Of Borrowing -

Replay Of 1997/98 Asian Financial Crisis?

More recently, we have seen some extended weakness on Asian FX, as a result of risk aversion or perhaps market covering their short USD positions in the spot market. As said before, one key factor that would determine the impact on Asia is cost of borrowing, the key transmission mechanism in the 1997/98 Asian financial crisis. And, the recent FX weakness has led to concern if this is another Asian FX crisis in the making. Our view is that such adjustment is not new, seen during the 2008 episode as well. Then, SGD depreciated more than 10%, from 1.35 to 1.55 between Sep 2008 to Mar 2009 (see table). If 2008 is any guide, Asian FX still have downside risk -- of course, the extent will depend

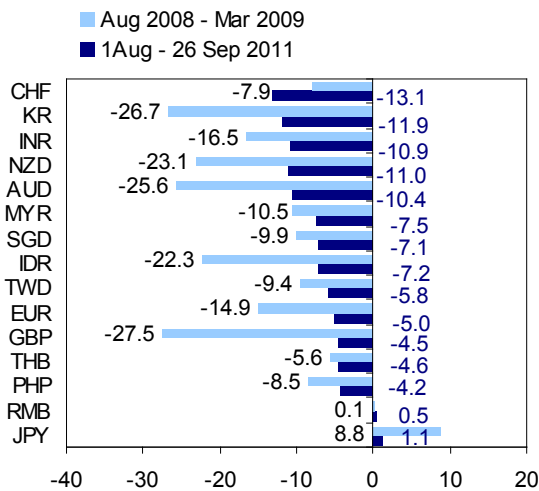


on developments in the European space. Also, as compared to the Asian financial crisis of 1997, fundamentals in this part of the world are definitely more stable today. Finally, so far, we have not witnessed sharp rise in short-end borrowing cost. Thus, our view is that it is more of a FX adjustment, rather than a FX crisis in the making.

If there is anything to take away, it is after last few years of USD weakness, we could be heading to a temporary bottom for USD/Asian -- at least until the situation in

Asia Focus

There Could Be More Downside To The Asian Currencies If The Current Situation Deteriorates To The Severity Of The Lehman's Failure



Source: Bloomberg

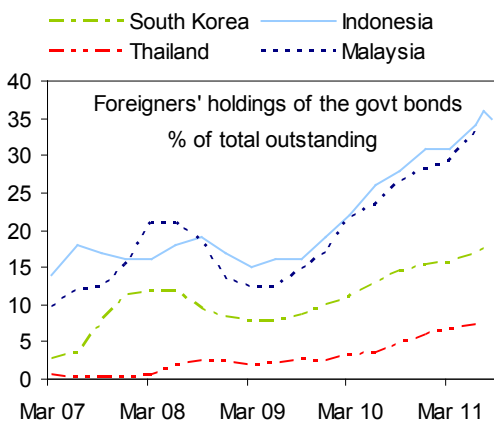
than a currency crisis in the making. Yields in Asia have not risen significantly but that will be the key to watch for signs of greater distress in the coming months.

Since the start of August, Asian currencies have depreciated by around 5% against USD. The largest drop was in the KRW which slumped more than 10%. Similarly, KRW also registered the sharpest drop to a low of 1,507.90/USD following the Lehman collapse from 1,015.75 prior to the crisis. The comparison drawn against 2008 suggests that there could be more downside to the Asian FX given that the Asian currency index fell around 11% back then.

Asian FX Reserves And Foreigners' Bond Holdings

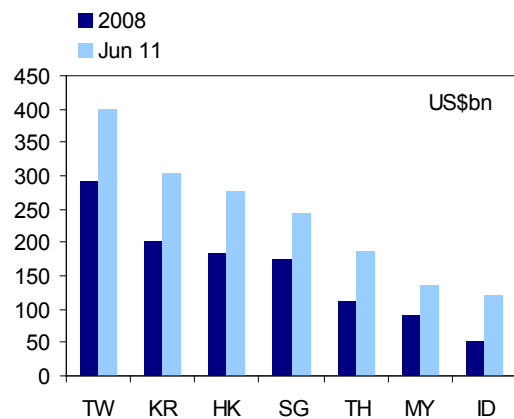
There are also concerns over the foreign funds pullout from the bonds and stock markets in Asia, particularly in

Large Foreign Holdings Of Asian Government Bonds Expose the Region To Risk Of Capital Flight



Source: CEIC, Bloomberg, UOB Economic-Treasury Research

Record High FX Reserves In Asia Instill Confidence In The Region



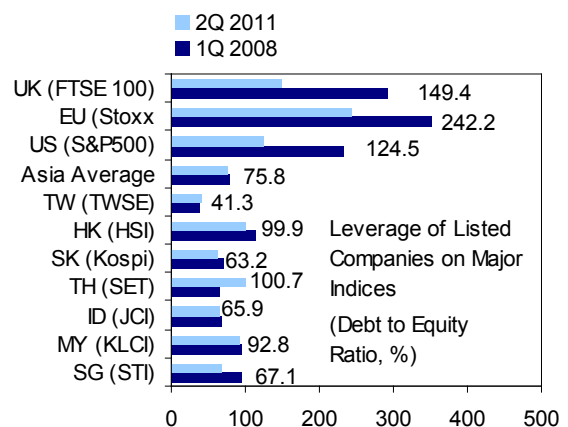
Source: CEIC, UOB Economic-Treasury Research

Europe stabilises. For now, Asian FX is likely to be choppy over the next few months, with the extent of the downside depending on developments in the European space.

Asian FX Weakness Since August 2011

Equity markets around the world have taken the brunt of the roiling Euro area sovereign debt crisis. And since late August, the impact was starting to visibly impact on Asian currencies as well. We saw short-term liquidation dynamics in Asian assets amid evaporation of risk appetite. The recent market mayhem triggered a significant pullback of foreign equity flows and with it a weakening of the regional currencies. We believe this is a currency adjustment rather

Asian Corporates' Leverage Ratio Has Fallen Since The Global Financial Crisis In 2008



Source: Bloomberg, UOB Economic-Treasury Research Estimates

Asia Focus

Foreign Holdings (US\$bn)			
	Of Total Outstanding Government Bonds (Aug 2011)	Net Purchase Of Domestic Equities (Jan 2002 - Aug 2011)	FX Reserves At End 2Q11 (US\$bn)
Indonesia	27.3	15.0	119.7
Malaysia	30.4	-	134.2
South Korea	53.3	-22.1	304.5
Thailand	5.9	4.8	184.9
Taiwan	-	63.6	400.3

Source: CEIC, Bloomberg, UOB Economic-Treasury Research

General Government Gross Debt (% of GDP)						
Country	2000	2008	2009	2010	2011F	2014F
Advanced Economies						
Germany	59.7	65.9	72.5	76.7	79.6	82.0
Greece	103.4	99.2	115.1	133.2	145.2	146.1
Italy	109.2	106.0	115.8	118.6	120.5	123.9
Japan	142.1	194.7	217.7	227.1	234.6	247.7
Portugal	50.5	66.3	77.1	86.6	91.8	97.1
US	54.8	70.6	83.2	92.6	97.4	106.4
Asia						
Hong Kong	-	1.2	1.0	0.6	0.6	0.5
South Korea	16.7	29.0	32.6	33.3	32.8	28.5
Singapore	84.1	84.8	90.9	88.0	85.1	78.2
China	16.4	16.8	18.9	20.0	19.8	19.7
Indonesia	95.1	33.2	28.6	27.5	26.4	23.8
Malaysia	35.3	43.0	54.9	57.2	58.6	61.4
Philippines	62.1	48.6	48.9	48.0	46.9	40.5
Thailand	57.0	37.6	44.2	47.9	49.8	52.2

Source: IMF

Current Account In Asia (% of GDP)					
Country	2008	2009	2010	2011F	2012F
Singapore	18.5	17.8	18.2	20.5	19.5
Indonesia	0.0	2.0	0.8	0.5	0.4
Malaysia	17.7	16.5	11.5	11.1	10.7
Thailand	0.7	8.3	4.6	5.0	4.2
Taiwan	6.6	11.0	9.8	7.7	6.9
South Korea	0.3	3.9	2.8	1.6	1.3
Hong Kong	13.6	8.7	6.1	6.4	5.6
China	9.3	6.1	5.1	2.9	2.4

Source: CEIC, UOB Economic-Treasury Research Estimates

Fiscal Balance In Asia (% of GDP)					
Country	2008	2009	2010	2011F	2012F
Singapore	0.1	-0.3	1.9	0.9	0.3
Indonesia	-0.1	-1.6	-0.7	-1.7	-2.0
Malaysia	-4.8	-7.0	-5.6	-5.6	-5.4
Thailand	-1.1	-3.9	-2.5	-3.5	-4.0
Taiwan	-0.7	-1.1	-1.3	-1.2	-1.0
South Korea	0.3	-4.1	-1.1	-2.0	-1.5
Hong Kong	0.1	1.6	4.2	0.6	0.8
China	-0.4	-2.3	-1.7	-0.2	-0.5

Source: CEIC, UOB Economic-Treasury Research Estimates

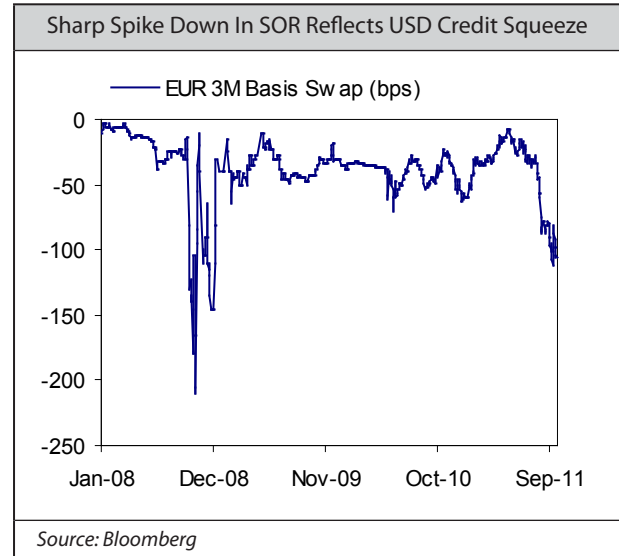
Asia Focus

emerging markets such as Indonesia and Malaysia where foreigners hold a third of the outstanding government bonds. Nonetheless, our calculations indicate that the FX reserves in these countries are significantly higher compared with the foreigners' investments in the country's government bonds and equities (since 2002). From the FX perspective, this is some reassurance that the impact from large outflows from these countries will be manageable.

Asian Economies - Stronger Balance Sheets To Take Shocks But Still Not De-Coupled (Only Less Coupled)

The economic outlook and the sovereign debt situation for the G3 markets are indeed worrisome developments for Asian economies. Asia (excluding Japan) is not decoupled from the G3 markets, but rather it is better insulated, cushioned by the rising domestic demand as well as increasing consumption in China and India. Asia also stands out in terms of its strong economic fundamentals, including current account surpluses and stronger fiscal positions compared with the troubled West. Asian corporates have cut back on leveraging since the Lehman crisis, thereby increasing their resilience should credit or liquidity conditions weaken.

But even as Asian inflation remains elevated at this juncture, growth concerns are thrown to the forefront on the back of a higher risk of US dipping back into recession and more significantly, the roiling European sovereign debt crisis with its contagion threat to the banking sector. While we still do not expect a US double-dip, the US recovery is likely to be sluggish in the foreseeable future. The US consumer is the Achilles' heel of the economy and consumption demand will remain depressed as long as the economy is hobbled with an anemic housing market and the continuing deleveraging process of household debt.

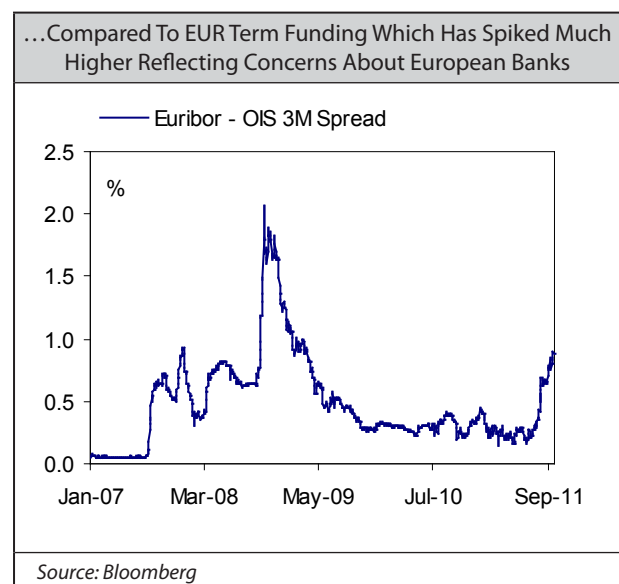
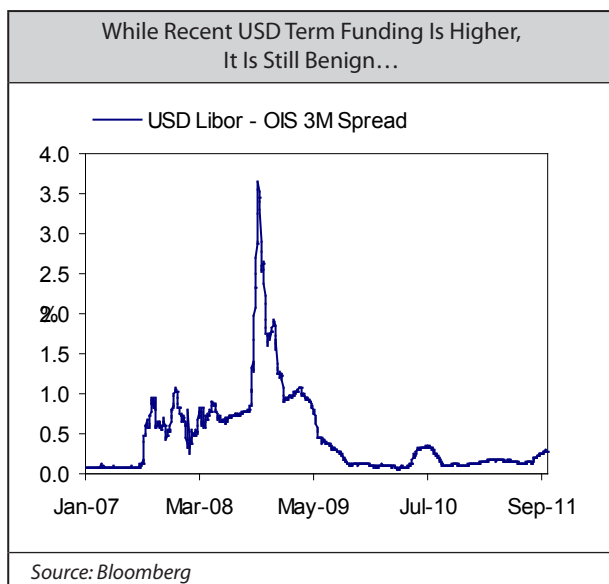


But, Still Have To Watch Europe

Our biggest concern is Europe. The Greek sovereign debt crisis looks to be without a viable short term solution. We have put together key dates to watch in the coming weeks that would have material impact in global system (Please see section on Euro-zone developments and outlook on page 13). And while September was a challenging month to say the least, October will not be any easier with many key events taking place that can make or break the whole situation.

Liquidity And Credit Channels Not Lehman Yet But Strains Clearly Showing

We articulated in our earlier research reports, one aspect that pronouncedly damaged the global system in 2008 was not the asset-backed securities (ABS), or the collateralized debt obligations (CDO), but it was the drying up of liquidity



Asia Focus

and credit post-Lehman's failure. USD and EUR funding are definitely tighter than before, as banks turned risk averse and became more cautious of counter-party risk.

Relooking At S\$SOR To Explain The USD Funding Issue

The SOR is a FX-implied rate (or a derived interest rate) derived from USD/SGD forward rate, USD/SGD spot exchange rate and USD SIBOR. As it is an implied rate, there is no floor to SOR and it can be negative which it did on 10 August 2011. Since then, most of the SOR term rates returned back to the positive territory. The 6M SOR was the last one to conclusively return to the black on 20 September 2011 following the significant weakening of the local currency against the USD. (6M SOR was at 0.059% as of 27 September).

Singapore operates a S\$ FX monetary policy, unlike most markets that uses interest rates as the monetary policy tool. To combat rising inflation, the Monetary Authority of Singapore has tightened monetary policy since April 2010 via the appreciation of SGD. The market has been taking short USD/SGD position and the onshore market is flushed with SGD liquidity. Since Singapore does not have an interest rate policy and capital flows freely, domestic interest rates are thus determined mainly by market forces and are strongly correlated with US rates.

Conditions that made it possible for SOR to turn negative were US Fed Reserve promising to keep its interest rates at 0-0.25% at least till mid-2013 and MAS having an appreciating SGD FX policy. But both conditions already existed before 10 August. The nail that drove SOR negative

was that the scramble for USD term funding by some banks (European names) via using SGD forwards to swap their SGD to USD.

The Issue Is Shortage Of USD Credit, So Developments On This Front Bears Close Watching

Even as there was ample USD liquidity, concerns about the health of some banks (which are perceived to be more exposed to the on-going EU sovereign debt crisis) made counterparty banks turn risk averse.

This situation is similar to the "Lehman crisis" episode whereby USD term borrowing froze up due to counterparty risk, but this is still no where near the severity experienced during the Lehman crisis where the Libor-OIS spread spiked up to more than 200bps. After trending below 20bps for 1H 2011, the spread began to move up since August and was just below 30bps in the last few weeks of September. This still relatively high compared to the average of 2010 and 1H 2011 but no where near the record highs seen during the Lehman crisis.

The spike is more material in the Euribor-OIS spread, reflecting the squeeze in term money within the European space. The spread is at 0.875% (as of 27 Sep 2011), the highest since March 2009. As far as the market is concerned, we will continue to keep an eye on the European Libor-OIS spread over the next few weeks especially as the EU sovereign debt crisis may see unexpected negative developments. If liquidity does dry up, the situation in Asia could change materially.

USD Higher On Risk Aversion												
	CHF	NZD	AUD	KRW	MYR	SGD	TWD	EUR	THB	GBP	IDR	RMB
01-Aug-11	0.784	0.877	1.097	1,050.40	2.946	1.202	28.838	1.425	29.71	1.630	8464	6.434
30-Sep-11	0.900	0.766	0.975	1,178.05	3.190	1.298	30.517	1.354	31.17	1.558	8808	6.387
% change vs USD	-13.0	-12.7	-11.1	-10.8	-7.7	-7.4	-5.5	-5.0	-4.7	-4.4	-3.9	0.7

Source: Bloomberg