ASIA

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Note Released: 14-Sep-07

Asia Macro Views

How Would Fed Cuts Affect Asia?

Key points

- **The Fed is likely to cut the Fed funds rate by 50bps on September 18 and by another 25bps before year-end to offset tightening financial conditions**
- **A modelling simulation suggests that 75bps of Fed cuts could boost US and Asian growth by 0.8ppt, strengthen Asian currencies by 0.7% and improve Asian current accounts by 0.1% on average**
- **But these results may be misleading if looked at in isolation. If the rate cuts completely offset the slowing US economy, then changes in growth, currencies and current accounts are likely to be marginal**
- **In the likely scenario that the rate cuts are not sufficient to prevent slowing of the US economy, Asian growth would slow and Asian currencies would weaken**
- **The overall conclusion from this exercise is that Fed cuts are positive for Asia. But until the outlook for the US economy becomes more certain, we should stay cautious on Asian asset prices**

Expected rate cut by the Fed

Recent data suggest that the future path of the US economy remains highly uncertain. Housing prices have declined by an average of 8%, but elevated levels of unsold homes suggest that further corrections are likely. A lack of confidence in money and commercial paper markets contributes to the risk of a credit crunch and financial disintermediation.

The overall financial conditions tightened during the past three months. Deviation from the mean of Citi's Financial Conditions Index shifted from +0.5 sigma in June (looser than average) to –0.4 sigma in August (tighter than average). The non-farm payroll data for August was a blow to economists who believe the economy outside the housing sector might be able to stay unaffected.

We now expect the Fed to cut the overnight target rate by 50bps at an FOMC meeting on September 18 and by another 25bps before year-end. As Fed Chairman Bernanke indicated recently, future Fed decisions will be more determined by a forward-looking assessment than past economic data.

Aggressive Fed cuts could impact Asia significantly. This is primary because of high degrees of trade and financial interdependence between the US and Asia. We have argued that the recent subprime crisis in the US could affect Asia through the following channels:

- Losses caused by direct exposure to subprime-related securities
- Consequences of the global repricing of risks

- ➤ Spillovers of the credit crunch in the industrial world
- ➤ Impact of a potential US recession

While the picture is not yet entirely clear, with a few exceptions, Asian financial institutions probably have limited direct exposure to subprime and related securities (see figure below). A US recession is probably the most serious risk for Asian economies.

Likely Exposure of Asian Institutions to Subprime Assets

China	BOC and ICBC disclosed US$10.9bn of subprime CDOs
Hong Kong	Most banks have exposure to synthetic and CDOs, but little to subprime
India	Almost no exposure
Indonesia	BI said almost none
Korea	Around US$900m US CDOs, of which probably around 20% is subprime
Malaysia	BNM said almost none
Philippines	BSP said almost none
Singapore	Around US$1.7bn, of which around US$570m is ABS-CDOs
Taiwan	FSC said US$1.3bn, which was probably underestimated
Thailand	BoT said almost none. Only Bank Thai said has US$50m

Source: Citi compilation.

Simulating a Fed rate cut and slowing US growth

To gauge the likely effects of the Fed's rate cuts, we apply the Oxford Macroeconomic Forecasting Model (OEF) to run a couple of simulations. The first simulation assumes a reduction in the Fed funds rate by 75bps before the end of 2007 and the rate stays at 4.5% in 2008. The left panel of the following table reports the simulation results for 2008 (see figure below).

OEF Model Simulation: Fed Rate Cut by 75bps and Slowing US Growth

	Fed 75bp Cuts				Slowing US Growth			
	GDP	FX/$	C/A	Fiscal	GDP	FX/$	C/A	Fiscal
China	1.1	-0.8	0.2	0.1	-1.1	0.9	-0.3	-0.1
HongKong	0.8	0.0	0.5	0.0	-0.9	0.0	-0.5	0.0
India	0.4	-0.6	0.0	0.2	-0.4	0.5	0.0	-0.2
Indonesia	0.8	-0.9	0.1	0.2	-0.9	0.8	-0.1	-0.3
Korea	0.7	-0.8	-0.1	0.2	-0.8	0.7	0.0	-0.2
Malaysia	0.4	-0.5	0.0	0.2	-0.4	0.4	0.0	-0.3
Philippines	0.7	-0.8	0.1	0.3	-0.8	0.7	-0.2	-0.3
Singapore	1.4	-0.6	0.3	0.2	-1.4	0.6	-0.3	-0.2
Taiwan	0.7	-0.7	-0.1	0.2	-0.8	0.7	0.1	-0.2
Thailand	0.8	-0.8	0.1	0.2	-0.9	0.7	-0.1	-0.2

Source: Citi application of the OEF model.

The effects appear to be relatively large. The rate cut boosts US GDP growth by 0.8ppt. At the same time it also accelerates Asian growth by an average of 0.8ppt, strengthens Asian currencies by an average of 0.7%, and improves Asian current account and fiscal balances by 0.1% of GDP and 0.2% of GDP, respectively. The growth effects are greater in China, Hong Kong, Indonesia, Singapore and Thailand. The Chinese yuan, Indonesian rupiah, Korean won, Philippine peso and Thai baht also gain more significantly from stronger US growth and lower Fed funds rate.

Interestingly, current accounts improved in most Asian economies, except in Korea and Taiwan, despite strengthening of the currencies against the dollar. Most Asian currencies actually weakened on real effective exchange rate terms. For instance, the same simulation shows appreciation by 1.8% for the Japanese yen, 1.6% for the euro and 1.4% for the Australian dollar.

Looking at the simulation results of a Fed funds rate reduction in isolation, however, could be misleading. The main reason for the aggressive call on the Fed funds rate is potential weakening of US growth. In fact, our US colleagues' call of 75bps in cuts is based on consideration of the needed change to shift the financial conditions index back to the levels in June (or completely offset the tightening during the past three months).

Assuming the purpose of the cut is to restore financial conditions and therefore growth performance, we need to build in a potential slowing of the economy before analyzing the impact of rate cuts. In the second simulation, we shock the total factor productivity to generate a slowing in GDP growth by 0.8%. The results are reported on the right panel of the above table (see table above).

Dividing changes in Asian growth by 0.8 provides the growth effects or elasticity. For instance, a 1ppt slowdown in the US could reduce GDP growth by 1.4ppt in China; 1.1ppt in Hong Kong, Indonesia and Thailand; and 1.8ppt in Singapore. These numbers are very similar to the elasticity data we reported in a report two weeks ago, which were based on an earlier set of economic data.

Slower US growth weakens Asian currencies except the Hong Kong dollar, especially the Chinese yuan and Indonesian rupiah, and worsens Asian current accounts, especially those in China, Hong Kong and Singapore.

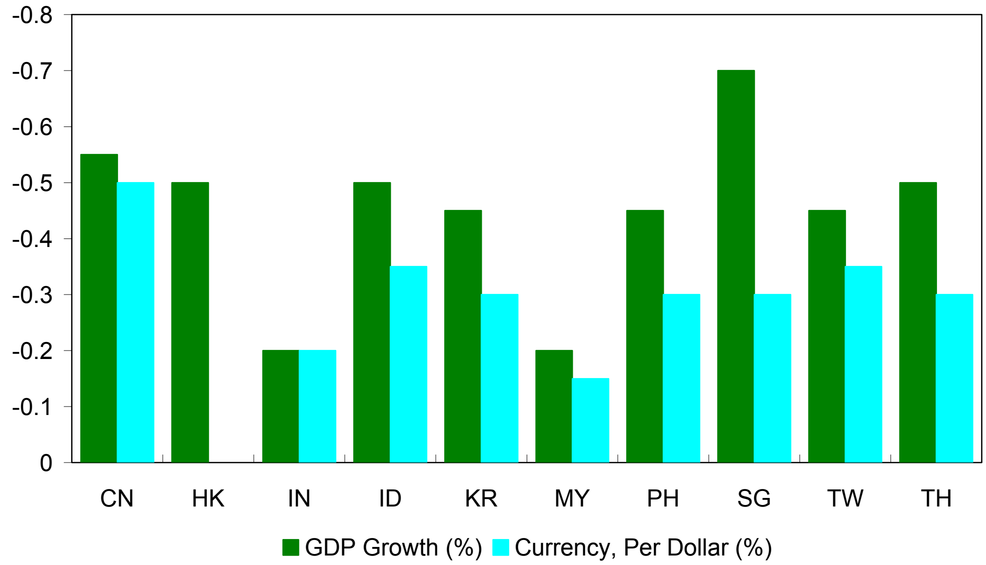
Given that the model is additive, we can add the results of the two simulations together to see the net impacts of rate cuts responding to slowing growth. Interestingly, the net impacts are tiny. It reduces GDP by around one-tenth of a percentage point in most Asian countries but strengthens their currencies by 0.1%.

Market implications

The assumption that Fed cuts completely offset US growth weakness is very strong. In a likely scenario where growth still ends up slower despite a rate cut, we will probably see somewhat slower growth, weaker currencies and worse current accounts.

As an illustration, we generate a scenario where US growth slows by 0.8ppt initially and the Fed rate cuts are able to offset only half of that slowing (see figure below). In this hypothetical scenario, Asian growth would slow by an average of 0.5ppt, Asian currencies weaken by 0.3% and Asian current accounts deteriorate by 0.1%. The impacts on China are relatively large.

OEF Model Simulation: US Growth Slows by 0.8ppt, but Rate Cut Offsets Only Half of That (%)



Note: Here negative numbers for the currencies mean % weakening.
Source: Citi application of OEF Model.

The above exercises suggest that Fed cuts should be generally positive for the US and Asia. But in a likely scenario where the cuts are not sufficient to prevent slowing of the US growth momentum, we should stay cautious on the outlooks for Asian assets, including currencies and equities.

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