| Special Report |

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Greece’s impact on Asia and the Middle East

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- We examine the impact of the Greek debt crisis on Asia and the Middle East
- We examine the four channels of impact: bank lending, portfolio flows, trade and asset prices
- Markets will be hit in the near term by uncertainty and profit-taking
- Overall, contagion should be limited
- But economies with weak or vulnerable fiscal and external payments positions are at risk
- Sri Lanka, Vietnam and Pakistan warrant attention
- We remain positive about Asia and the Middle East

Introduction

This note focuses on the impact of the Greek debt crisis on Asia and the Middle East. Before looking at those regions in detail, however, it is important to have a clear view of how developments could unfold in Greece and Europe. We continue to monitor these developments in other reports. It must be stressed that this is a dynamic situation with many possible outcomes. That being said, our view is that the aid package to Greece will avert a default but that it will not prevent present market worries from escalating, or prevent contagion to other parts of Europe. We believe Greece will implement austerity measures, condemning it to depression but avoiding a near-term default; a restructuring is likely, but in the future rather than now. Portugal, despite measures taken, will not be helped by growth and will likely also need help from the centre. Spain, like the UK, has a high deficit but relatively manageable debt levels. Like the UK, it faces austerity at home, not default. Belgium and Italy, within the euro area, face debt problems but may not be attacked by speculators (certainly not Belgium, anyway).

There are downside risks to this outlook. Growth will not save the deeply flawed euro area. Yet we are also seeing a rebalancing. The core, led by Germany, is benefiting. The periphery is being re-priced.

Continental Europe's key economy, Germany, will benefit from a weaker euro, boosting its formidable export machine, and will be helped by lower bond yields. German consumers, like others across Europe, may suffer from a dip in confidence. But it is firms and consumers on the periphery that will suffer most.

It is against this backdrop of a clearly diverging euro-area outlook – core versus periphery, exporters versus consumers, and low-debt versus at-risk countries – that one needs to judge the contagion, or perhaps lack of it, to Asia and the Middle East.

In addition to fierce popular opposition in Greece, there may be constitutional hurdles in Germany. But Greece's EUR 8.5bn refinancing on 19 May will proceed, as a number of euro-area countries plus the IMF have indicated that they will release their tranches of the loan. Yet the markets remain unconvinced of Greece's commitment to austerity. There are plenty of examples of countries which have achieved a similar scale of deficit reduction and have avoided recession by devaluing their currencies and cutting interest rates. But Greece does not have these options.

Long-term worries over the future of the euro area will persist. While a break-up of EMU makes no sense for high-debtor countries, it may yet make sense for the core, comprised of a smaller number of credible countries. But contagion has spread to Portugal and Spain; Portugal, which is smaller than Greece, should be containable, but bailing out Spain could require a loan package several times the size of the Greek package. The EU is now addressing this risk with the launch of its latest substantial crisis package. Spain's fundamentals – relatively low debt/GDP at 53.2% of GDP in 2009 (versus a euro-area average of 78.7%), a much lower reliance on foreign investors than Greece, and an AAA/stable rating confirmed by Fitch (despite the recent S&P downgrade to AA) – would in normal times make the need for an emergency loan unthinkable. But these are not normal times, and a further rapid loss of market confidence is probable. In this environment, the European Central Bank (ECB) will step in to ensure that there is adequate liquidity for the region's banks, and could even resort to buying sovereign bonds in the secondary markets. It will keep policy rates low for some time.

Emerging Asia and the Middle East are better insulated

How will this crisis hit the rest of the world? It may be a bigger issue for other advanced nations than for emerging markets, given the advanced economies' relatively worse fiscal positions and higher public debt burdens, as indicated in Charts 1 and 2.

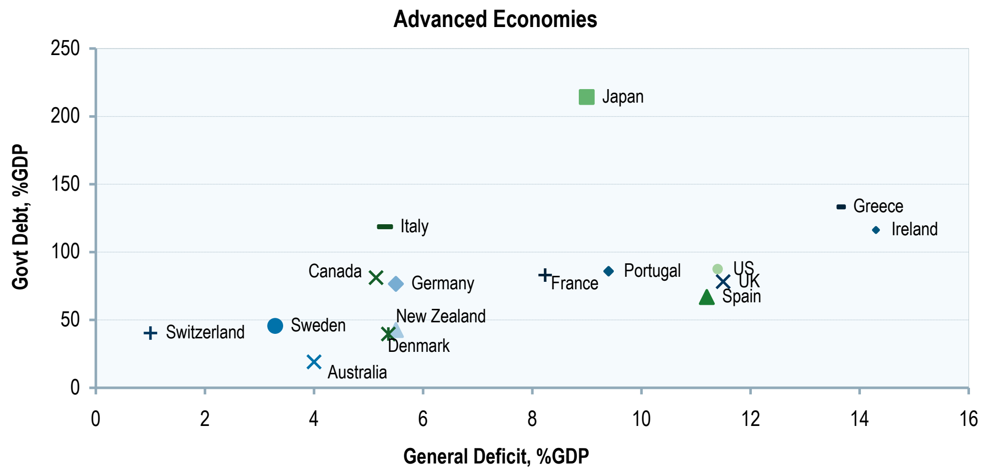
However, with markets concerned about sovereign debt, any country in – or close to – a debt trap would face problems. A debt trap is where debt is bigger than the size of the economy, and is growing because the interest rate paid on it is higher than the rate of economic growth.

Japan, with government debt almost double its GDP and weak growth, looks more at risk than others, despite high savings. But so far, the market has been accepting of Japan's predicament. Whether that will persist must now be questioned. Whether the market will tolerate US and UK debt levels also needs to be assessed. Neither the US nor the UK is in a debt trap, and both can work their way out of their troubles, but their situations point to domestic austerity.

In contrast, in emerging economies – especially in Asia and the Middle East, where fiscal positions are healthier and growth momentum is relatively strong – the risk of contagion or of falling into a debt trap is less severe. Since the bankruptcy of Lehman Brothers, markets remain highly vulnerable to shocks; it is therefore not surprising to see relatively sharp reactions in equity and currency markets across the emerging-market (EM) economies. However, as shown in Table 1, overall market reactions in Asia and the Middle East are yet to match the scale of the post-Lehman period, especially in interbank and commodities markets. Aside from the initial reactions being felt in most emerging markets, the longer-term damage should be confined to economies with weak fiscal and external payments positions, like Pakistan, Sri Lanka and Vietnam. Countries with widening fiscal gaps or relatively large foreign funding needs – like India, Thailand, the Philippines, Malaysia and Indonesia – may also face short-term pressure, but their track record of improved fiscal discipline and reduced public debt burdens over the past decade should better insulate them. In fact, similar to the financial crisis of the past two years, this latest event could further differentiate economies with good housekeeping, especially in emerging Asia, from those that have done a bad job.

Chart 1: Fiscal and debt positions compared

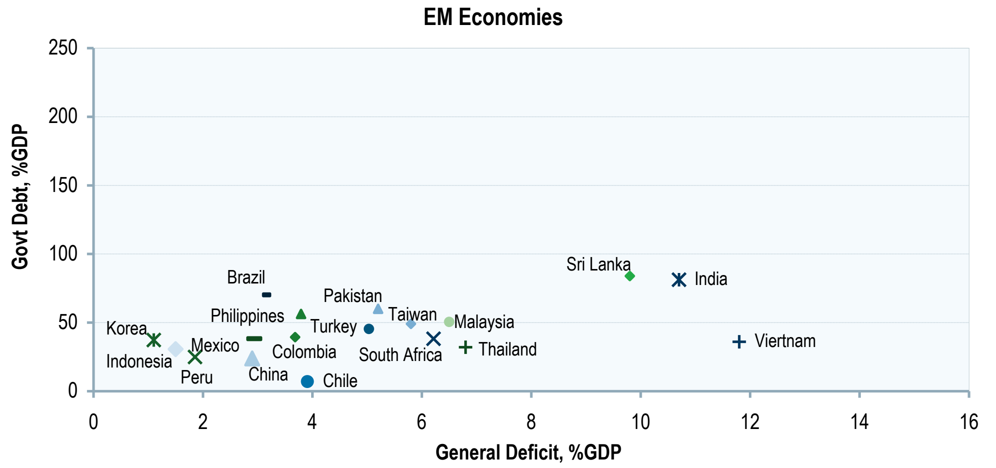
(Advanced economies, 2009)



Sources: Moody's, Fitch, S&P, Standard Chartered Research

Chart 2: Fiscal and debt positions compared

(EM economies, 2009)



Sources: Moody's, Fitch, S&P, Standard Chartered Research

Table 1: Market reactions to crises compared

	Lehman collapse	Greece crisis
Equity	MSCI AXJ receded 1.6% and DJIX fell 4.4% on the trading day after Lehman filed for bankruptcy, but MSCI AXJ and DJIX edged up 1.3% and 0.9%, respectively, in the next five trading days. Chinese equities rallied immediately after Lehman collapse but the KOSPI fell by over 11%, while India's Sensex started to fall just ahead of the Lehman collapse and only troughed over a month later. The BGCC200 covering the Middle East started to fall in August 2008, reaching a floor only in March 2009 at below half its peak. During that period, option volatility increased and the VIX index increased by 6.8%.	Asian stock exchanges (except Vietnam) fell as the crisis intensified. China's equities fell the most in the last month, losing over 14%, while Hong Kong lost almost 10% and Taiwan 7%. This was partly driven by China's monetary tightening. Middle Eastern prices were broadly stable. Option volatility increased, with the VIX index up 4.5% during the period.
Credit	Contagion effect on Asia was limited: iTraxx Asia investment-grade CDS index fell 7.3% in the five days after Lehman bankruptcy, reflecting a narrowing spread, probably due to flight to quality.	iTraxx Asia investment-grade CDS index edged up by 5.0% in the five trading days after Greece was downgraded to junk status. The move may have partly reflected political events in Thailand and general elections in the Philippines.
FX	USD weakened at the initial stage of Lehman crisis. DXY receded 0.1% on the day of the bankruptcy and 3.5% in the subsequent five trading days. During the same period, AUD and EUR gained 4.7% and 3.7%, respectively, IDR gained 1.7%, JPY fell 0.84%, and KRW fell 2.1% on balance-of payments concerns.	USD strengthened after Greece downgrades on the back of safe-haven flows. DXJ index rose 0.8% on 27-Apr and gained 1.4% in the subsequent five trading days. During the same period, KRW depreciated 0.45%, IDR 0.17%, JPY 1.6%, AUD 0.7% and EUR 1.4%.
Commodity	Gold prices rose 3.0% on the day of Lehman bankruptcy on risk aversion, then rose 14.5% in the next five trading days. Oil prices receded by 4.14% on the first day but rebounded by 11% in the subsequent five trading days due to lingering effect of the commodities rally.	Gold and oil market reactions were largely subdued. Gold prices increased by 0.8% and oil prices fell 0.13% on the day of the Greece downgrades, then both fell 0.1% in the subsequent five trading days. Oil prices have since fallen to below USD 78 (WTI).
Interest rates	3M HKD HIBOR rose 77bps and 3M SGD SIBOR rose 42bps in the five trading days after the Lehman bankruptcy, while 3M LIBOR surged 38.1bps and 3M EURIBOR gained only 2.5bps during the same period.	3M HKD HIBOR rose marginally. by 1bp, and 3M SGD SIBOR was unchanged in the first five trading days after Greece downgrades. During the same period, 3M LIBOR was up by 5.9bps, and 3M EURIBOR up by 2.75bps.

Sources: Bloomberg, Standard Chartered Research

Who is most vulnerable?

Given the nature of the Greek crisis, countries with relatively weak fiscal positions are naturally perceived by investors as more vulnerable. There are many ways to measure fiscal strength, including budget deficits, debts levels and dependency on foreign funding, or size of foreign debt.

Among Asian countries, Vietnam is running the largest fiscal gap, at 11.8% of GDP in 2009. It is followed by India (10.7%), Sri Lanka (9.8%), Thailand (6.8%), Malaysia (6.5%), Taiwan (5.8%) and Pakistan (5.2%) – see Table 2. None of these deficits matches Greece's 13.6% estimate, and most (except those of Vietnam, India and Sri Lanka) are less than half the Greek level. Yet attention should be paid to the sharp widening of Vietnam's fiscal deficit, which shot up from 4.8% of GDP in 2008 and is expected to stay high at 8.3% in 2010. Concerns about Vietnam are s also fuelled by its relatively large current account deficit, at 7% of GDP in 2009 (expected to widen to 8.5% in 2010). While the trade account deficit narrowed to USD 3.63bn in Q1-2010 (from USD 5.6bn in Q4-2009), the risk is that a worsening external trade environment will hit Vietnam's exports, widening the trade deficit in the next few quarters.

Table 2: Comparative debt profiles, selected economies

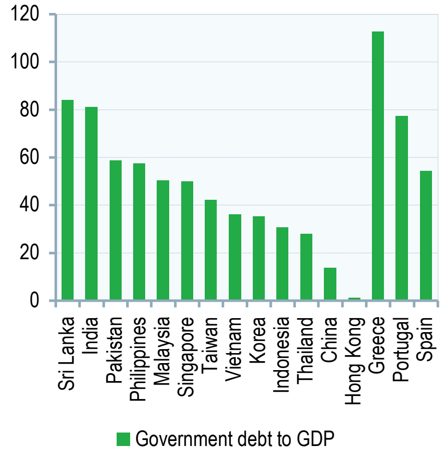
	Fiscal balance as % of GDP, 2009	General government debt as % of GDP, 2010	Net external debt as % of GDP, 2010*
Ireland	-14.3	116.3	-73.3
Greece	-13.6	133.3	75.4
Vietnam	-11.8	36.2	25.3
United Kingdom	-11.5	78.2	28.9
United States	-11.4	87.5	42.8
Spain	-11.2	66.9	84.7
India	-10.7	81.2	-5.4
Sri Lanka	-9.8	84.0	50.0
Portugal	-9.4	85.9	79.9
Japan	-8.8	214.3	-50.2
Thailand	-6.8	32.0	-44.2
Malaysia	-6.5	50.5	-32.7
Taiwan	-5.8	49.1	-149.8
Italy	-5.3	118.6	38.1
Pakistan	-5.2	58.8	-31.5
Australia	-4.0	19.1	47.9
Philippines	-4.0	57.5	12.2
China	-2.9	23.9	-50.9
Saudi Arabia	-2.0	4.3	-107.7
Indonesia	-1.5	30.7	16.0
Korea	-1.1	37.3	-5.0
Hong Kong	1.0	2.1	-248.2
Singapore	10.6	46.8	-104.9

**Negative figures indicate a net external assets position;* Sources: Moody's, Fitch, IMF, EC, S&P, Standard Chartered Research

In terms of government debt to GDP, the region's most indebted countries include Sri Lanka, India, Pakistan, Malaysia and the Philippines (Chart 3). India's debt-to-GDP ratio is relatively high, at about 79% – but still less than two-thirds the Greek level, and more importantly, most of it is in local currency, which limits vulnerability to external speculation. However, Sri Lanka, which is under IMF assistance and has a fiscal deficit of 9.8% of GDP and a debt-to-GDP ratio of over 80%, could be vulnerable given its heavy reliance on foreign short-term financing and its current high spending commitments. Vietnam, however, appears better positioned than Sri Lanka in this respect given its modest government debt-to-GDP ratio of about 36%.

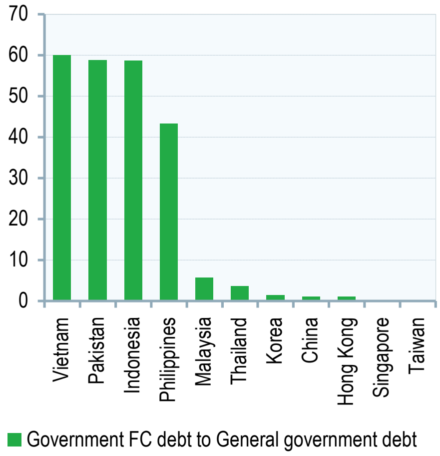
Pakistan and the Philippines have relatively high percentages of foreign-currency government debt (Chart 4), although the Philippines receives significant inflows of FX-denominated remittances – a useful cushion which grew even during the crisis in 2009. Vietnam and Indonesia also stand out. However, with estimated FX reserves of USD 16bn (Vietnam) and USD 70bn (Indonesia), which cover about three to nine months of imports, these two should be better cushioned from any short-term funding squeeze. The rest of Asia is generally much sounder, as debt is largely domestically funded. We also need to take into account that some countries, like the Philippines, have high holdings of USD debt by onshore investors.

Chart 3: Government debt to GDP
(2009)



Sources: Moody's, Standard Chartered Research

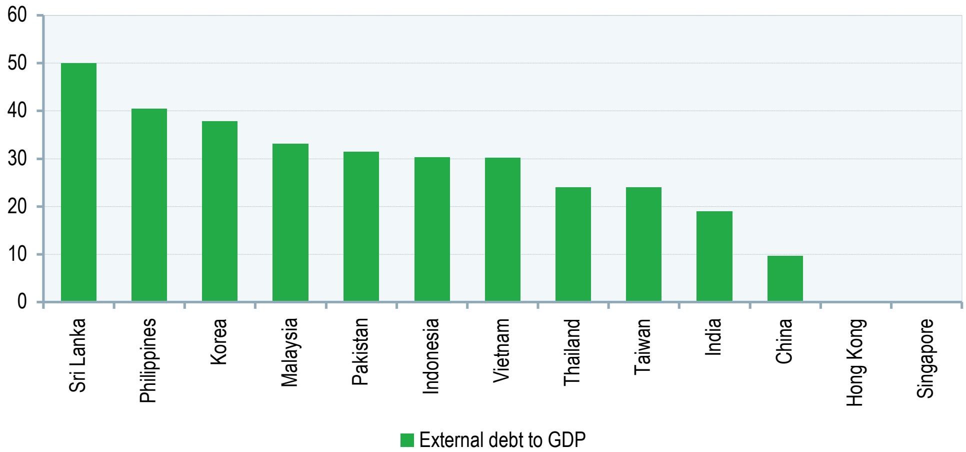
Chart 4: Government FX debt
(Foreign-currency/total, 2009)



Sources: Moody's, Standard Chartered Research

Chart 5 shows external debt to GDP. Sri Lanka, on the left, is in the worst shape. The Philippines stands out in terms of total (public plus private) external debt to GDP, followed by Korea and Malaysia. The high ratios of Korea and Malaysia are more due to private-sector debt, which implies less of a sovereign problem. Where data are available, we have also seen a marked increase in foreign ownership of Asian local-currency government bonds in recent years. For example, foreign holdings of Indonesian rupiah (IDR) government debt rose from 17% at end-2008 to 24% in April 2010. In Malaysia and South Korea, the ratios rose from 13% and 9% at end-2008 to 21% and 12% in March 2010, respectively.

Chart 5: External debt to GDP, 2009 *(%)*



Sources: Moody's, Standard Chartered Research

Even Thailand, where the political situation has kept foreign investors cautious towards the local bond market, has seen an increase. However, foreign ownership is not necessarily a problem – it may be seen as a positive sign for those countries with sound, or improving, fundamentals.

In Indonesia, foreigners have absorbed more than the net increase in outstanding bonds so far this year. Even during the financial crisis of the past two years, the decline in foreign ownership of Indonesian bonds was limited (ownership fell to about 14%). Given the outlook for Asian economic outperformance, we do not foresee a major change in foreign holdings. More importantly, the Indonesian government has actually been over-funding itself.

From a sovereign standpoint, Asian and Middle Eastern foreign-currency debt markets are very small. The combined size of emerging Asia's USD, EUR and JPY debt markets is around USD 308bn. When compared with the region's official foreign reserves of USD 5.2trn (as of end-2009), this is not that large. In contrast, the combined size of the region's domestic debt markets is around USD 4.4trn. China makes up around USD 2.6trn of this, which is not excessive given the country's USD 4.9trn GDP – the third-largest in the world.

As indicated in Table 3, we believe the sovereign credit ratings of Vietnam, Pakistan and Sri Lanka are at relatively higher risk of being jeopardised by the crisis in Europe. But much will depend on these governments' resolve in preventing a further deterioration of their fiscal and external payments positions.

Table 3: Risk ratings of selected Asia economies based on sovereign credit outlook

Low risk	Medium risk	High risk
Indonesia (BB)	India (BBB-)	Pakistan (B-)
Malaysia (A-)	Philippines (BB-)	Sri Lanka (B)
China (A+)	South Korea (A)	Vietnam (BB)
Singapore (AAA)	Thailand (BBB+)	
Taiwan (AA-)		
Hong Kong (AA+)		

Note: S&P long-term foreign currency sovereign ratings are in brackets; Sources: Bloomberg, Standard Chartered Research

Four different channels of impact

So far, Asian credit markets have shown only a limited impact from the Greek situation. The same goes for the Middle East. Dubai, for example, is largely unaffected by the debt woes in Greece; it has its own issues to contend with, and the focus is entirely on its own debt restructuring. However, if the crisis escalates, Asia will be affected via the following four channels:

1. Bank lending from Europe. The banking sector in continental Europe would be badly impacted by an outright default in Greece, which would hit its bond holdings. There has already been some impairment to valuations of Greek assets that will hit banks' balance sheets. Of the USD 217bn in cross-border bank borrowing by Greece at end-2009, continental European banks accounted for 80%, or USD 174bn. While this only accounts for 1.1% of continental European banks' total cross-border lending, if the contagion were to spread to Portugal, Ireland and Spain, as much as USD 1.5trn (or 9.7%) of European banks' cross-border lending could be affected. This would then affect their ability to lend to Asia. Risk aversion would impact credit spreads globally, and higher spreads would impact lending within Asia, both in terms of liquidity and cost of funding.

As of end-2009, continental European banks accounted for 25%, or USD 434bn, of total BIS bank lending to emerging Asia. This is smaller than the 33% share (USD 578bn) of the UK banks, which overtook the Europeans as the single largest group of lenders to emerging Asia in 2009. In fact, since mid-2008, continental European banks have cut their lending to Asia. In H2-2008, these banks had cut their lending to emerging Asia by USD 147bn, accounting for 60% of the USD 250bn withdrawn by all BIS banks from Asia. In 2009, even when other lenders – especially US and Japanese banks – had boosted their lending to Asia back to beyond to pre-Lehman levels, continental European banks cut their lending to Asia by another USD 77bn. Hence, a Greece-triggered bank retrenchment could see a re-acceleration of withdrawals by continental European banks from Asia in the coming months. The only comfort we may draw is that, given continental European banks' reduced share of the Asian lending market, Asia should see a less severe withdrawal of cross-border bank flows this time (assuming events in Greece do not trigger another round of global bank retrenchment).

Among the Asian economies, a retrenchment in European bank lending could hurt Vietnam, Singapore, the Philippines and India the most given their relatively large dependence on European banks (Table 4). In contrast, Malaysia, Hong Kong, Thailand and Taiwan are less exposed to such risk.

As for the Middle East, BIS banks had about USD 300bn of exposure at end-2009, of which about one-third (or USD 113bn) was lent to the UAE. This was followed by Saudi Arabia (USD 43bn), Qatar (USD 42bn) and Egypt (USD 38bn). Compared with Asian economies, Middle Eastern countries are generally more dependent on continental European banks, with their share of lending ranging from 32% to 94% (see Table 4). The only exception is Jordan, which relies heavily on UK banks. Hence, should there be further retrenchment in European bank lending, the Middle East could be hit harder than Asia.

Table 4: Continental European bank lending to Asia and the Middle East, end-2009
(USD bn)

	Continental European/total	Continental European banks	Total BIS banks' lending
Vietnam	29.5%	3.7	12.6
Singapore	28.9%	61.0	210.6
Philippines	26.4%	6.1	23.2
India	25.9%	53.3	206.0
Indonesia	24.4%	18.5	75.8
Korea	23.0%	72.1	313.0
Pakistan	21.5%	2.4	11.3
China	21.0%	48.5	230.8
Taiwan	20.4%	21.4	104.8
Thailand	13.7%	7.8	57.0
Hong Kong	12.2%	48.4	396.7
Malaysia	10.7%	11.1	103.8
Emerging Asia total	**24.9%**	**433.9**	**1,745.7**
Iran	93.8%	5.2	5.6
Iraq	68.5%	1.0	1.5
Egypt	63.2%	23.9	37.8
Lebanon	54.5%	2.4	4.5
Israel	53.1%	7.0	13.1
Saudi Arabia	52.1%	22.6	43.4
Qatar	48.3%	20.4	42.2
Oman	44.6%	3.5	7.9
Kuwait	36.2%	7.4	20.3
Bahrain	33.8%	7.0	20.9
UAE	32.4%	36.5	112.7
Jordan	17.1%	0.6	3.5
Middle East total	**43.9%**	**137.5**	**313.4**

Sources: BIS, Standard Chartered Research

2. Asia's exposure to securities issued by Greece and the other peripheral countries. Asia's portfolio investment in Greece amounted to USD 8.4bn at end-2008 (according to the latest data available – see Table 5). This is only 1% of Asia's USD 793.5bn portfolio investment in the euro area. Even including exposure to Spain and Portugal, Asia's portfolio holdings total USD 41.5bn, hardly 5% of the euro-area total. Typically, this paper is held by banks from Australia, Japan and, to a lesser extent, Singapore and Hong Kong. But their exposure is likely to be a very small portion of their overall balance sheets. Moreover, these banks are very well capitalised and should be able to weather the exposure fairly easily. Of Asia's USD 793.5bn of portfolio investment in the euro area, three-quarters (73.4%) is in Germany, France, the Netherlands and Belgium, which are likely to benefit from any major flight to quality triggered by the sovereign debt crisis. This should provide some comfort to Asian investors.

In the reverse direction, euro-area investors had invested USD 548.5bn in Asian securities at end-2008, 46% in Japanese paper and another 20% in Australia. Within emerging Asia, Korea, Hong Kong and China accounted for a total of USD 100bn of portfolio investment by euro-area investors – even less than the amount absorbed by Australia. In that sense, a withdrawal of European investors from emerging Asian markets should have a limited impact.

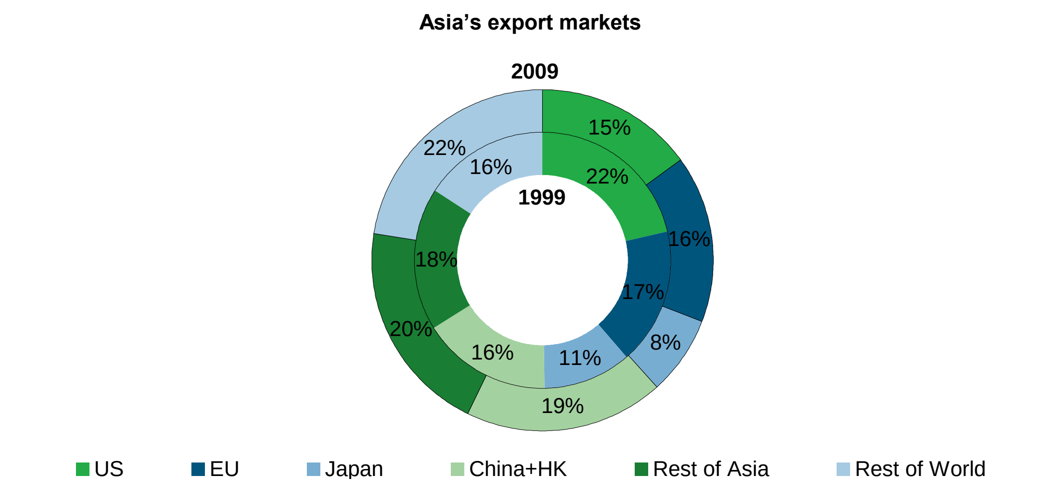
Table 5: Portfolio investment between Asia and euro area
(USD bn)

	Euro-area portfolio investment in Asia		Asia portfolio investment in Euro area
Japan	255.66	Germany	207.85
Australia	114.40	France	167.70
Korea	41.64	Netherlands	107.20
Hong Kong	29.90	Luxembourg	98.33
China	28.37	Italy	66.86
India	17.88	Ireland	55.31
Singapore	15.45	Spain	30.20
Taiwan	13.73	Belgium	18.92
Malaysia	8.75	Austria	17.39
Indonesia	6.94	Finland	11.31
Thailand	5.73	Greece	8.39
New Zealand	5.12	Portugal	3.01
Philippines	4.50	Cyprus	0.05
Vietnam	0.31	Slovak	0.01
Sri Lanka	0.09		
Total	**548.47**	**Total**	**792.53**

Source: IMF co-ordinated portfolio investment surveys

3. A collapse in trade flows and a retrenchment of trade finance. Chart 6 shows that the EU is a key export destination for many developing Asian economies. Europe represents a marginally bigger slice of Asia's trade than the US, even though the importance of both markets to Asia has shrunk over the past decade. Yet any significant slowdown in trade flows between Europe and Asia would still impact Asian growth, with the more export-dependent Asian economies being more severely affected than those with large domestic markets. In 2009, Asia's exports to the EU dropped by 17.4%, double the decline in sales to the US (8.2%) and more than the 14.1% drop in Asia's total exports.

Chart 6: Asia's major export markets
(Change from 1999-2009)



Sources: CEIC, Standard Chartered Research

In terms of individual economies, China sold 21% of its total exports to the EU in 2008, making it the most vulnerable Asian economy, followed by Hong Kong and Korea (14% each) and Singapore and Malaysia (11% each). That said, these ratios probably came down quite a bit during the financial crisis. According to IMF data, global exports contracted by 21.4% in 2009. This poses more of a risk to Asia than the Middle East, but Dubai will be affected due to its role as a global logistics hub, particularly as logistics is a key sector driving Dubai's current recovery. As the world's third-largest re-export centre, Dubai would be severely affected by a collapse in global trade.

Table 6: Top three export markets for selected Asian economies
(2008, % share of total exports)

	No. 1	No. 2	No. 3
China	**EU**	US	HK
	21%	18%	13%
Hong Kong	China	**EU**	US
	49%	**14%**	13%
India	US	UAE	China
	12%	10%	5%
Indonesia	Japan	US	Singapore
	20%	10%	9%
Korea	China	**EU**	US
	22%	**14%**	11%
Malaysia	Singapore	US	**EU**
	15%	13%	**11%**
Philippines	US	Japan	China
	16%	16%	11%
Singapore	Malaysia	US	**EU**
	12%	13%	**11%**
Taiwan	China	HK	US
	26%	13%	12%
Thailand	US	Japan	China
	13%	11%	11%
Vietnam	US	Japan	China
	19%	14%	7%

Sources: BIS, Standard Chartered Research

4. Asset-price inflation in Asia and decline in oil prices. There will be further pressure on the ECB to keep rates low. The reality is that the Fed, the ECB and the Bank of England (BoE) will need to keep rates low for some time, not just because of the euro-area crisis but also because of the need to nurture their domestic recoveries and to offset the impact of fiscal tightening. This low-interest-rate environment will feed capital flows into Asia, compounding liquidity problems there. Asset prices will rise. Macro-prudential measures will be the focus, as more countries across Asia will be reluctant to raise interest rates too much.

In comparison, the Middle East may face a higher risk of a drop in oil prices. Currently, most countries in the region need oil prices to be around USD 65 per barrel in order to fund their infrastructure projects. A sustainable drop in oil prices would have a significant impact on the entire GCC region.

Asian market implications

FX markets

The most vulnerable currencies in Asia ex-Japan (AXJ) appear to be the Korean won (KRW), Vietnamese dong (VND), Indian rupee (INR) and Philippine peso (PHP), based on (1) sovereign credit outlooks, (2) bank lending from Europe, and (3) trade linkages with Europe. Despite Indonesia's relatively solid external position and closed economy, the Indonesian rupiah (IDR) is also vulnerable given positioning. With the exception of the VND, the above-mentioned currencies are also the most volatile AXJ currencies, which tend to be hit the hardest when the markets panic. While China, Hong Kong, Malaysia and Singapore have close trade ties with Europe, these currencies are less vulnerable given that they are more managed; for example, the Singapore dollar (SGD) is often seen by investors as a safe-haven currency in Asia.

Moving beyond the sovereign debt crisis in the euro area, we recently highlighted that, from a seasonal perspective, risk appetite tends to deteriorate in May-June (for details, see **FX Alert, 23 April 2010, 'Asian currencies – Seasonal analysis of Asian currency returns'**). We have observed three key trends:

1. The *Standard Chartered Bank Risk Appetite Index* (SCB RAI) was most frequently in *Risk seeking* territory in August and October.
2. The SCB RAI was most frequently in *Risk aversion* territory in May and June.
3. The SCB RAI was never in *Risk seeking* territory in February or June (i.e., it was in *Risk neutral* or *Risk aversion*).

Our findings suggest that February is a time for caution, and that investors should avoid putting on carry trades in Q2. However, Q3-Q4 seems to be a much more favourable period for risk. The SCB RAI tends to enter *Risk seeking* territory in October, although seasonal patterns partly broke down in 2008-09 due to the magnitude of the global credit crisis. From an FX perspective, these seasonal patterns have implications for AXJ currencies. AXJ spot currency returns are typically poorer in Q2 and Q3, but significantly better in Q1 and (particularly) Q4 as risk appetite returns. Seasonal factors are strongest for the Thai baht (THB) and the Philippine peso (PHP), and much less present for 'pegged' currencies like the Chinese yuan (CNY) and Hong Kong dollar (HKD).

Seasonality, combined with positioning and technicals, suggests that AXJ currencies will weaken further before stabilising. While total-return investors such as leveraged funds and prop desks may have been squeezed out of their long AXJ positions, real money funds, which have a longer time horizon, remain significantly long AXJ currencies – especially in the likes of the KRW, IDR and INR. Meanwhile, USD-INR, USD-IDR and USD-KRW have broken key resistance levels, which warns of further gains near-term.

If the euro-area debt crisis becomes a global sovereign debt crisis, which we do not expect, all AXJ currencies will be hit very hard, despite strong fundamentals. This is due to the strong trade and financial linkages between Asia and the rest of the world. Medium-term, fundamentals matter, and assuming that a global sovereign debt crisis does not materialise, AXJ currencies should outperform again in H2 on the region's growth outperformance and strong external balances. A sharp slowdown in China and/or the US remains a medium-term concern, but this should take time to materialise.

Credit markets

We believe that investors should look to discriminate and use this opportunity to buy selectively, shunning the higher-risk assets such as marginal Chinese property-sector names and weaker sovereigns. Among corporates, investment-grade names should outperform high-yield names, while sovereigns with relatively sound fundamentals should outperform. Also, EM will outperform the developed world, since this is very much a crisis brought about by the weak public-sector debt outlook in the developed world.

Equity markets

Asian equity markets may continue to be dragged by the majors, but the region's strong fundamentals and relatively solid growth momentum should see an earlier or stronger recovery once the immediate market pressures are fully digested. Among the sectors, exporters may remain under pressure, especially those selling into European markets. This should put domestically driven sectors like retail in a better position to outperform.

Conclusion

Overall, the impact on emerging markets from the situation in Greece will be felt in a number of ways, as we have outlined here.

The situation is dynamic, for if problems mount, Greece may see restructuring as an attractive option – not this year, but at some future stage. Thus, this will be a live issue for some time.

Markets will focus on the exposure of sovereigns, with a particular emphasis on debt and fiscal positions. Current account deficits also need to be monitored closely.

We have identified six low-risk economies: Indonesia, Malaysia, China, Singapore, Taiwan and Hong Kong; four medium-risk economies: India, the Philippines, South Korea and Thailand; and three high-risk economies: Vietnam, Sri Lanka and Pakistan.

We also focus on the four main routes by which problems in Europe could impact Asia: (1) if European banks restrict their international bank lending, as roughly one-quarter of lending to Asia comes from Europe; (2) the small overall exposure of Asian portfolio investors to Greece and the peripheral euro-area economies, as well as the threat of euro-zone portfolio investors withdrawing from Asia; (3) direct trade exposure if European growth slows, as well as additional competitive pressure from Europe-based companies if the euro weakens; and (4) the impact on Asian asset markets.

Overall, while there are some particular concerns, contagion to Asia and the Middle East should be limited because their fundamentals are stronger.

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