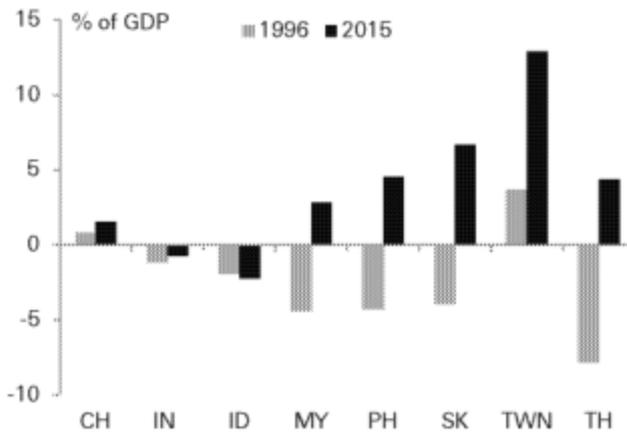


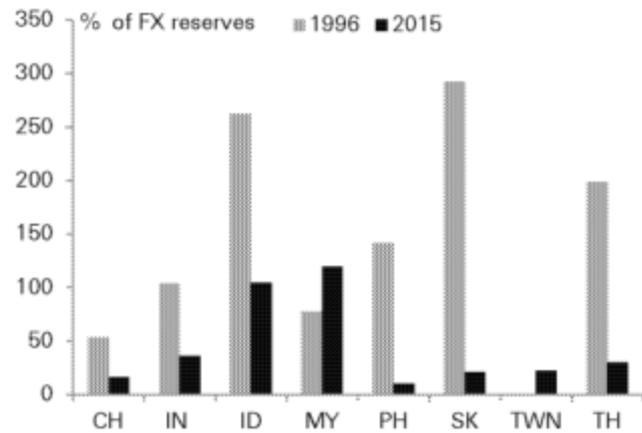


Figure 4: Current account balances in Asia



Sources: IIF and Deutsche Bank Research

Figure 5: External debt/GDP in Asia



Sources: IIF and Deutsche Bank Research

However, Indonesia and Malaysia stand out as having relatively high external financing burdens, and in Malaysia's case it is higher than it was as that country entered 1997. This explains, in our view, why these have been the relatively weak currencies over the past year or two. The vulnerability of these two countries is put in sharp relief when one considers that foreign investors own about 40% of the Indonesian government's local currency debt and about 48% of Malaysian government local currency debt. Particularly in Indonesia's case, where there is a current account deficit to finance, rising US interest rates pose a significant risk to the currency and perhaps to the bond market if those higher rates lead to a withdrawal – or even a stoppage – of capital inflows into the bond market.

Conclusion

If the Chinese government is no longer willing to prop up its equity market, that is a decision we applaud. It does imply, though, that that market may face considerable downward pressure with perhaps more than CNY1tn of margin financing possibly needing to be repaid and with prices today 28% higher than the prices for the same companies' shares listed in Hong Kong. Allowing the market to set the price of capital is the most important element of the government's economic reforms and as inconvenient as it may be to investors for the government suddenly to have decided to pursue this goal, if indeed that is what has occurred, it is fundamentally a thing to be welcomed.

Similarly for the foreign exchange market. For years, foreign governments, the IMF and most investors we've met have argued that China should stop intervening in the foreign exchange market and let the currency find its equilibrium level. If recent developments are a signal that they are moving in that direction then again, one cannot object.

But we would expect contagion from a further significant depreciation of the renminbi into global currency and capital markets to be much worse than what we have seen over the past couple of weeks in equity markets. The exchange rate is the most important price in a small open economy, so if China – everyone's competitor – devalues again (and that is not our expectation), it will likely have serious repercussions on currency values and asset prices everywhere.

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