

## After the Emergency Fed Cut: Implications for Asia's Monetary Policy

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As panic sell-off in equity markets accelerated around the world on 21-22 Jan, the US Federal Reserve on 22 Jan announced a surprise 75bps cut in its target overnight rate to 3.5% from 4.25%. This was the first inter-meeting rate cut since Sep 2001 and the magnitude of the move was the largest since 1994.

US investors were largely unconvinced of how much the US Fed could address in the current financial market malaise, as the Dow tumbled more than 459pts (3.8%) at the start of the session, and eventually ended Tue session -1.06% to 11971.19. The S&P500 fell -1.11% to end at 1310.50 and the Nasdaq Composite slumped 2.04% to 2292.27.

Fed fund futures have now fully priced in an additional 25bps cut and a 80% probability of a 50bps cut at next week's scheduled meeting. At this point, we maintain our call for a 50bps cut of the Fed funds rate to 3.00% at the scheduled 29-30 Jan meeting, next week.

On the currency market, uncertainty and risk aversion continue to dominate after the Fed rate cut, with the USD falling against most major currencies except the JPY, while other Asian currencies saw limited gains toward the end of the Ldn/NY session.

Asian equity markets rebounded in response to the surprise Fed move. However, moves on the STI suggest that market sentiment is still extremely jittery with its gyration into positive and negative territory. Amidst the panic selling earlier, one must recognize that valuations and economic fundamentals in Asia suggest that the sell-offs may be overly aggressive. Valuations in most Asian equity markets - except China and India - were far from excessive prior to the sell-offs, with P/E and P/B ratios within historical norms. In addition, economic fundamentals in Asia such as levels of savings, liquidity, and leverage, are much healthier today, and should be able to offset to a certain extent weaknesses from a slowdown in the US.

In the aftermath of the emergency Fed rate cut and with prospects of slower global growth and heightened risks of a US recession, we believe most ex-Japan Asian central banks could see downward pressure in their respective interest rate policy, or at least throttle back some of rate hike trend. However, domestic inflationary pressures - especially those arising from food, fuel, commodities prices - are expected to be one key factor keeping central banks on edge.

**Singapore:** 3-month SIBOR edged down sharply earlier in the year, ahead of the Fed meetings. The 3-month SIBOR eased further today (23 Jan) to 1.625% from 1.81% a day earlier, pricing in a US Fed funds rate of close to 2.0%. Downside remains for our forecast of 1.7-1.8% for 3-month SIBOR for 2008, in view of the latest Fed move. Despite higher inflation (CPI at +4.4%/y in Dec), there is limited scope for MAS to tighten SGD policy due to growth concerns.

**Malaysia:** Likely to keep its overnight policy rate of 3.5%, which has been in place since May 2006. Bank Negara has not much flexibility to cut given likely reductions in fuel subsidies ahead, which would add pressure on consumer prices.

**Thailand:** Benchmark 1-day repo rate of 3.25% is likely to see some downside risk as the new government which just took power is in talks to BoT as part of its plans to revive economic growth.

**Indonesia:** Limited scope for a cut in the 1-month BI rate of 8%, due to inflationary pressures and a weak rupiah. But policy move remains biased towards downside on grounds of growth.

**Hong Kong:** Pegged currency to the USD means lockstep interest rate moves. HKMA responded immediately with a 75bps cut in its base rate.

**Taiwan:** Interest rate cycle remains on the uptrend at least in the first half of this year to keep real interest rate in positive territory, but CBC could return to neutral in second half if aggressive US rate cuts and if a pro-business government lead to strengthening of TWD.

**China:** Shifted formally to tight policy mode at end-2007 in view of spike in inflation and liquidity. Lowered US interest rates will widen rate differentials in the months ahead, and this could lead to PBoC slowing its reserve requirement ratio and interest rate hikes compared to 2007.

**Australia:** Stronger than expected 4Q CPI suggests a 25bps hike for RBA on 5 Feb, but current market turmoil may tie its hands.

**New Zealand:** RBNZ is likely to stay on hold at 8.25% on 24 Jan as inflationary pressures continue to be a key concern in NZ.

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