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Market Insight

Would an Argentine devaluation affect Asian markets?

31 May 1999

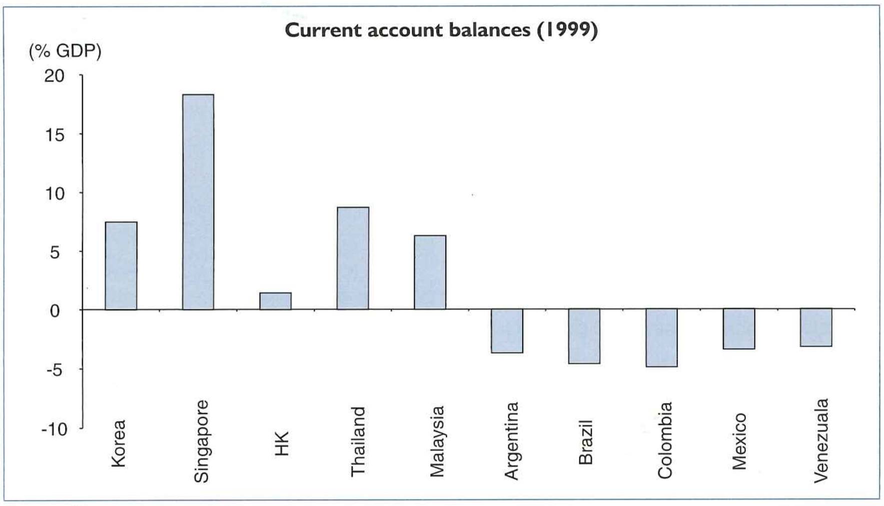
The possibility that the Argentine peso will be devalued has triggered concern that there will be another round of Asian devaluations.

We believe an Argentine devaluation to be unlikely in 1999.

If one were to occur, we believe it would not trigger another round of Asian devaluations. It is worth bearing in mind that Asia's external accounts are significantly stronger than Latin America's.

Because of a perceived parallel between the currency board systems of Argentina and Hong Kong, an Argentine devaluation might well trigger some speculation against the Hong Kong dollar.

We believe that anti-Hong Kong dollar speculation would be unsuccessful, but it might well create a relatively short period of higher interest rates and a temporary decline in the equity market. Any such decline would be a Hong Kong buying opportunity, in our view.



Source: Datastream

William H. OVERHOLT
(852) 2536-1850
Adrian FOSTER
(852) 2536-1849

Nomura Asia

Argentine devaluation unlikely

Concern is growing that a possible Argentine devaluation could trigger another round of global, and specifically Asian, devaluations and associated stock market collapses. We believe that this scenario is highly unlikely, though an Argentine devaluation could prompt a speculative attack on Hong Kong, with significant short-term market consequences.

First, we believe an Argentine devaluation to be unlikely. While there seems to be a widespread belief in the market that the peso is perhaps 10% overvalued, the country is not experiencing massive capital flight or other triggers of an early devaluation. A recent widening of interest rate spreads and declines in Latin American equity markets appear to be derived more from the US Federal Reserve Bank's recently announced tightening bias than from concerns about Argentina. Moreover, Argentina has enough dollars to convert all of its currency into dollars if necessary, so a devaluation cannot be forced.

This is the last year in office for President Menem, who has built his self-esteem and his place in Argentine history around the success of the currency board system, and it is unlikely he would accede to devaluation pressures unless forced to do so by the most extreme circumstances. None of the candidates to succeed him is advocating either a devaluation or a change in the currency board system. Controversy has concentrated heavily on whether to defend the stability of the currency and the economy by converting the Argentine currency into US dollars.

Second, if an Argentine devaluation did occur, we do not believe it would force another round of major Asian devaluations. Circumstances have changed. The round of currency devaluations that Asia saw in 1997-98 resulted primarily from short-term debt crises. Three countries — South Korea, Thailand and Indonesia — had accumulations of short-term debt that were greater than their foreign exchange reserves. Moreover, they had financial bubbles at home that made a large variety of companies vulnerable to higher interest rates or other problems that affected their cashflows. As these credit problems became evident, foreign banks pulled their loans and a sudden, widespread, desperate need for dollars drove up the price of dollars. That short squeeze in dollars was what came to be known as the currency crisis.

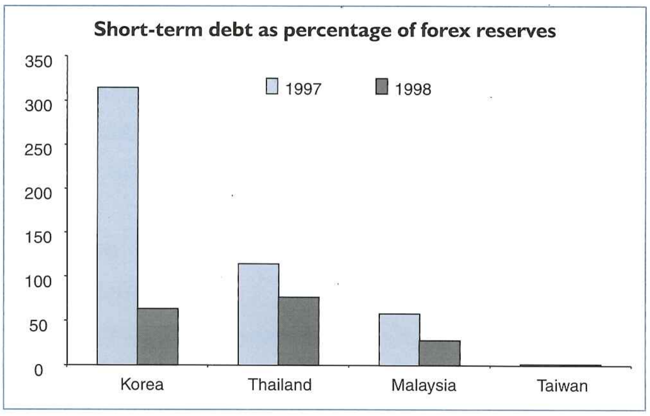
Speculators discovered they could profit by attacking the currencies, thereby driving up interest rates and popping the financial bubbles; they could then profit either from the currency short squeeze or from shorting the stock market as high interest rates and credit problems drove down the markets.

There were limited knock-on effects in neighbouring countries. Malaysia's ringgit came under extreme pressure even though Malaysia's debt position was sound, because the rhetoric of some senior officials created fears of capital controls, which greatly enhanced capital flight and thus caused the capital controls to become a self-fulfilling prophesy. Taiwan devalued for competitive reasons. Hong Kong suffered high interest rates but not devaluation.

The primary driver of the currency crisis was not competitive devaluation. The scope of the devaluations in Indonesia and South Korea was not determined by the size of Thailand's devaluation but rather by the severity of the short squeeze in each country as foreign capital departed the economy.

Asia's debt problem reduced

We argued in January (*Asia's bubble crisis: no easy cure*, 19 January 1999) that the market held an implicit model of competitive devaluation which was invalid. It was because of this invalid model that Asian markets feared the consequences of potential Brazilian or Chinese devaluations. If one applied the correct model — namely a model of short-term debt crisis — then the Asian currency crisis was over and Asia was no longer vulnerable to another round of crisis. In particular, Asia had nothing to fear from a Brazilian or Chinese devaluation.



Source: Datastream, IIF

The reasons for this are straightforward. No Asian country other than Indonesia continues to have a big overhang of short-term debt.

The Asian bubbles, whose popping precipitated the debt crisis, are largely gone. And, unlike the Latin American situation, the current account deficits that were rampant in 1996-97 are gone as well.

Finally, most Asian currencies are floating more freely now than they were in 1997, so pressures do not build up in the way they used to. The obvious exceptions are China, where the currency is pegged without a currency board and the black market rate is 9% below the official rate, and Hong Kong, where the currency board forces the real economy rather than the currency to adjust.

Hence, Asian countries are no longer vulnerable to the kind of currency domino effect that shook markets in 1997 and early 1998. This is not to say that very large movements in the yen-dollar rate, to take an obvious example, would have no effect. It is to say that we are back to normal, largely marginal currency adjustments.

This hypothesis was seriously tested by the Brazilian devaluation earlier this year. Because the markets were still thinking in terms of an erroneous competitive devaluation model, the Brazilian devaluation resulted in two days of mild volatility, but aside from that there were no significant Asian consequences. Latin America has been a different story because it has continued to suffer from substantial debt overhang, current account deficits and financial bubbles.

The effects of an Argentinean devaluation would be precisely analogous to the Brazilian devaluation. But Argentina's economy is only half the size of Brazil's. There is very little direct competition between major Argentinean exports and the exports of most Asian countries other than China, so we would expect the trade consequences of any Argentine devaluation to be minimal.

The effects of the Asian "currency crisis" on Asian stock markets derived from several sources. First, extremely high interest rates to protect currencies drove down markets by themselves and caused corporate earnings to decline or the companies themselves to collapse; today's currency situations and policies no longer would require such high interest rates. Second, financial bubbles created corporate and bank domino effects, with disastrous consequences for the markets; today, those bubbles have already popped and the affected corporations and banks have already collapsed. Third, serious current account deficits required austerity measures to reduce import demand; today, all Asian countries with serious stock markets are running substantial current account surpluses.

The psychological link

In addition to the general economic links, there is a psychological link between the Argentine currency peg and the Hong Kong currency peg. The success of Argentina's peg has often been cited as a reason for believing in the strength of the Hong Kong currency peg and vice-versa. Conversely, a break in Argentina's peg would cause speculative juices to flow regarding the Hong Kong peg.

We are inclined to believe that the speculation would be short-lived because so much money has been lost in the past speculating against the Hong Kong peg and because the differences from Argentina's situation are great. Although Argentina's peg looks superficially stronger, given that its dollar backing is stronger, the institutional fundamentals behind Hong Kong's peg are sounder.

In particular, Hong Kong's banking system is one of the world's strongest and its leading companies are very conservatively financed. In our view, Hong Kong's property bubble has mostly, though not completely, deflated; and the Hong Kong economy appears to be at the bottom of a cycle and due for a very gradual recovery. Its prospects would be much poorer if it were still riding on the old property bubble. But the property market and the stock market could take a significant short-term hit from a speculative attack; we would see that as a buying opportunity, because the peg would survive and the market would likely bounce back shortly.

In short, we think an Argentine devaluation is unlikely in 1999, and if it did occur we foresee minimal medium-term economic consequences for Asia. In our view, any market consequences would be heavily focused on Hong Kong and would be relatively short-lived.

ASIA EQUITY RESEARCH GROUP

Hong Kong

Nomura International (Hong Kong) Ltd
20/F, Asia Pacific Finance Tower,
Citibank Plaza, 3 Garden Road,
Central, Hong Kong
Tel: (852) 2536-1111
Fax: (852) 2536-1818

Singapore

Nomura Singapore Ltd
No. 6 Battery Road #34-01,
Singapore 049909, Singapore
Tel: (65) 420-1811
Fax: (65) 420-1932

Bangkok

Capital Nomura Securities Public Co, Ltd
21/3 Thai Wah Tower, 15th Floor,
South Sathorn Road,
Bangkok 10120, Thailand
Tel: (662) 285-0060
Fax: (662) 285-0717

Sydney

Nomura Australia Ltd
Level 32, Colonial Centre, 52 Martin Place,
Sydney, NSW 2000, Australia
Tel: (612) 9321-3500
Fax: (612) 9321-3990

Kuala Lumpur

Nomura Advisory Services (Malaysia) Sdn Bhd
Suite No 16.3, Level 16, Menara IMC,
8 Jalan Sultan Ismail,
50250 Kuala Lumpur, Malaysia
Tel: (603) 236-6811
Fax: (603) 236-6899

Taipei

The Nomura Securities Co, Ltd
Taipei Branch
14/F, 109 Min-Sheng East Rd, Sec 3,
Taipei, Taiwan
Tel: (886) 2-2547-9300
Fax: (886) 2-2547-9387

Seoul

The Nomura Securities Co, Ltd
12th Floor, Youngpoong Bldg,
33, Seorin-Dong, Chongro-Ku,
Seoul 110-752, Korea
Tel: (822) 399-6085
Fax: (822) 399-6690

Tokyo

International Equity Research Unit
Investment Research Department
Financial Research Centre
The Nomura Securities Co, Ltd
6/F Urbannet Building, 2-2,
Otemachi 2-chome,
Chiyoda-ku, Tokyo 100-8130, Japan
Tel: (813) 5255-1662, 5255-1787
Fax: (813) 5255-1759, 5255-1749

Asia Economic Research Unit
Center for Knowledge & Creation
Nomura Research Institute, Ltd
4/F, Shin Otemachi Building, 2-1,
Otemachi 2-chome, Chiyoda-ku,
Tokyo 100-0004, Japan
Tel: (813) 5203-0402
Fax: (813) 5203-0498