Trouble in the U.S. and European banking sectors has raised concerns that we could be seeing the start of another financial crisis. To what extent will this affect Asia and the continent's growth prospects? Sue Trinh, Co-Head, Global Macro Strategy of Multi-Asset Solutions Team, highlights her thoughts.

Assessing the contagion risk from ongoing banking concerns to Asia

Authorities on both sides of the Atlantic wasted no time in moving promptly and decisively in the hope that their actions will restore market confidence. Despite their best efforts, investors' nerves remain frayed.

Enormous uncertainties continue to weigh on sentiment as markets worry about the health of banking sectors, the potential economic fallout arising from last week's events, and implications for central banks—most of which are still trying to tame inflation. We consider possible channels through which contagion might be transmitted to Asia.

Direct exposure to failed/ailing banks remains low, but…

At this time, exposure appears to be limited. While several companies within Asia's venture capital and tech start-up sectors have exposure to these banks, they appear to be small in scale and few have openly admitted to seeing major losses.

If problems in the U.S. and European banking systems were to become more acute and investor risk aversion to spike, it's fair to say that Asian economies with large current account deficits—and therefore are reliant on foreign capital flows—will be most affected.

In general, we think current account deficits in Asia are benign, with the exception of New Zealand, the Philippines, and Thailand (deficits in these economies exceed 3% of GDP[1]). Although there are signs of strain, most measures remain far below crisis levels. Many Asian currencies have actually *appreciated* against the U.S. dollar (USD)[1] since the banking issues came to light.

Domestic credit conditions are likely to tighten

Financial conditions have tightened since March 9, although conditions remain looser than they were in the middle of last year[1]; however, lower confidence and greater risk aversion among domestic banks could result in weaker lending growth.

More broadly, tighter credit conditions and slower global economic growth will likely increase the risk of nonperforming loans. Understandably, the most exposed economies in the region would be those that have experienced sharp increases in interest rates and a significant rise in debt servicing costs—South Korea, for instance, could be a concern here.

Economies with many financial institutions with low regulatory capital could be left more vulnerable than others, and India could be a candidate in this regard.

Tighter global financial conditions could also weigh on Asian exports as demand weakens**.** Economies that are particularly dependent on trade with the United States and the eurozone would be most affected; Vietnam, Malaysia, and Taiwan would fall into this category.

[1] Bloomberg, as of 17 March 2023.

What does this mean for domestic monetary policy in Asia?

In our view, there are several scenarios for monetary policy paths in the region.

1. **Business as usual—**In the past year, Asian central banks have formulated their approach to monetary policy based on domestic inflation developments to a much greater extent than the U.S. Federal Reserve during this rate-hike cycle. In this regard, many central banks in the region have already made a dovish pivot—for example, Thailand and Vietnam. The Philippines and India, however, have suffered setbacks in their fight against inflation recently. As a result, we believe the Reserve Bank of India (RBI) and Bangko Sentral ng Pilipinas (BSP) are biased toward further tightening at their next meeting.

2. **The banking sector fallout prompts a lower policy path—**In this scenario, we expect the RBI and BSP to tread more cautiously and could potentially end their rate-hike cycles sooner than they had meant to.

3. **Strains in the financial sector get worse, funding costs and USD spike—**If this were to happen, some central banks in the region may be forced to hike further than otherwise would be the case to support their currencies. This is primarily a risk for those economies that have limited foreign currency reserves and are, as a result, highly dependent on foreign capital flows. Thailand, the Philippines, India, Indonesia, and Malaysia have become increasingly concerning in this regard.

Unrealized bond losses on the portfolio—could that affect banks in Asia?

Theoretically, the same problem that caused the collapse of a tech-focused lender in the United States recently could surface in Asia's banking sectors too; however, just because something could happen doesn't mean it will. In our view, it's more of a wildcard.

Crucially, potential contagion to Asian banks emanating from this episode seems limited: Banks in the region are well capitalized and direct exposures are small in scale. In addition, liquidity coverage ratios are high and deposit bases also tend to be stickier. It's also worth noting that corporate deposits are well diversified across industries.

In our view, direct contagion from the recent banking scare to Asia is largely limited, to the extent that financial and macro stability positions of economies in the region are generally more robust than previous crises. Far more important to the Asian regional outlook is the event's impact on global growth, USD funding conditions, and USD strength. If the global economy manages to avoid a hard landing, and USD funding costs remain low (with the USD staying below its 2022 peak), Asia should be able to weather the storm.

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