

Weekly Watch

Asia

22 July 2011
Economic Analysis

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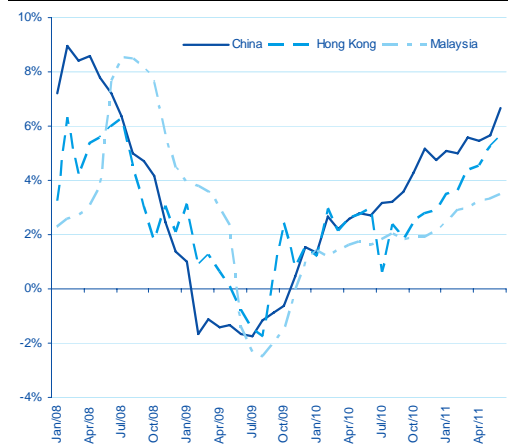
Inflation still casts a shadow

Despite signs that headline inflation may have peaked in some economies (such as China, Indonesia, Korea, and Singapore), underlying price pressures continue to mount across the region (Chart 1). This is creating challenges for policy makers as they seek to lighten the impact of rising living costs on low income segments of the population. The latest signs of rising inflation this week came from Hong Kong, where June inflation reached a 3-year high of 5.6% y/y on rising food and housing costs, and in Malaysia where it rose to 3.5% y/y as expected. In Singapore, the MAS revised its 2011 inflation forecast upward to a range of 4-5 percent (in line with our own projection) from 3-4 percent previously (see Markets). We expect many of the region's central banks to continue raising interest rates, but at a gradual pace given risks to the external outlook.

Strong exports in Japan raise hopes of a rebound

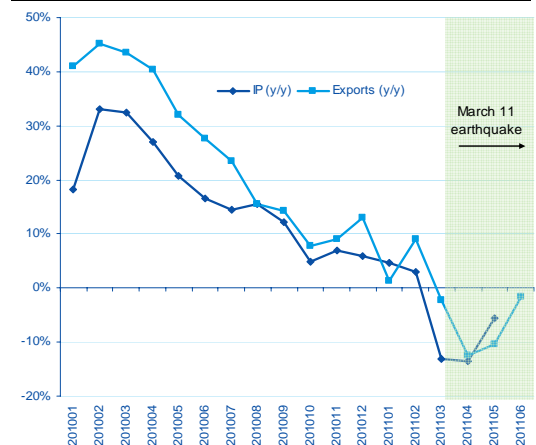
Japan's June exports surprised to the upside (-1.6% y/y; consensus: -4.9%), and the trade account turned to surplus, providing further evidence of a resumption of supply chains as the country struggles to regain its footing after the March 11 earthquake and tsunami (Chart 2). Markets are watching for the release of additional key indicators next week on industrial production and other activity indicators to gauge the pace of the rebound, which is looking increasingly strong. In addition to the Japan data, next week will feature Q2 GDP data for Korea (see Weekly Indicator) and Taiwan, and inflation in Australia.

Chart 1
Inflation is still rising in many parts of Asia



Source: BBVA Research and Bloomberg

Chart 2
Japan's exports continue to rebound



Source: BBVA Research and Bloomberg

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Who will pay the bill for China's 2008-09 fiscal stimulus?

China's high local government debt is likely to be borne by banks and the central government

China signals plans to extend curbs on housing purchases to smaller cities

With signs of cooling in the big cities, smaller cities are now expected to see the largest price gains

Strong economic fundamentals add appeal to Asian currencies

Currency markets are optimistic on Asia's prospects, with little fallout from the Europe's debt crisis

Economic Analysis

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Markets

Asian markets rallied towards the end of this week thanks to the positive announcements following the EU Special Summit on Thursday. As risk aversion receded, regional stock markets finished the week in the black and Asian currencies appreciated modestly against the USD.

Asian markets still dominated by European and US news

Friday saw a return of risk appetite following a favorable outcome from the EU Special Summit in which EU leaders agreed to augment the flexibility of the EFSF to intervene in the secondary debt markets and quell speculators. On Greece, they announced EUR159 bn in new aid. The maturity of EFSF loans to Greece is to be extended and lending rates lowered. Encouragingly, the lower interest rates apply to Ireland and Portugal as well. Greek debt holders will exchange maturing bonds into 30-year maturity debt fully or partly collateralized, providing EUR13.5 billion of relief to Greece's debt burden. While this may imply a downgrade of Greek debt to "selective default", ECB's Trichet stepped back from his previous stance and signaled the possibility to accept "defaulted Greek debt" as collateral. Decisive actions taken by EU leaders are seen as significant risk-on factors and pushed EURUSD up over 200 pips. But the responses of Asian FX were relatively muted, as many of them were already at or close to multi-year highs and have not exhibited high sensitivity to negative European headlines in past months.

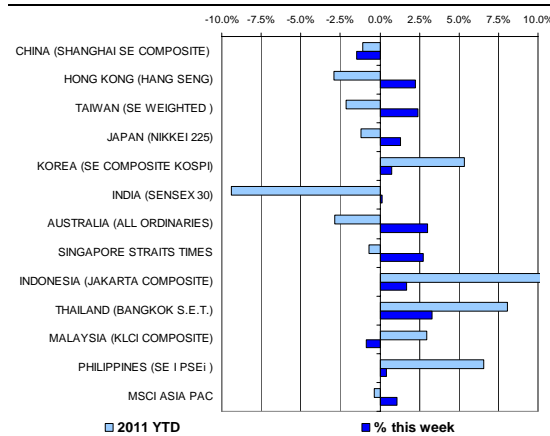
Markets anticipate Australia's RBA to cut rates

The Australian central bank shifted to a more neutral stance following its July policy meeting, as the governor said growth may not be as strong as earlier forecasts. Markets quickly moved to price in a rate-cutting scenario, with OIS curve projecting more than 50 bps cuts over the next 12 months. The expectation moderated this week, to 39 bps, after the RBA policy minutes Monday offered no surprises. Our economists hold the view that the rate hike cycle has not come to an end. They believe a pick-up in growth in H2 will keep labor markets tight to convince the RBA to raise rates again latter this year. With US rates expected to stay on hold, rate spreads will likely remain a supporting factor for AUD. Markets will monitor closely Q2 CPI inflation (due on July 27), which set to be an important element shaping RBA's policy going forward.

Monetary Authority of Singapore (MAS) raises inflation forecasts

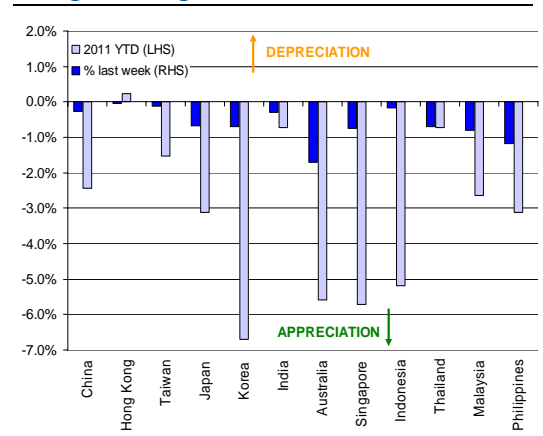
In its annual report, the MAS revised upwards its headline CPI forecast for 2011 to between 4 and 5 percent, up from previous 3 and 4 percent range. MAS said the upward revision came on the back of higher rent and faster increases in private road transport costs. However, the MAS added that the outlook for core inflation stayed unchanged, and core is still their preferred measure of inflationary pressure. GDP growth forecasts also remained intact at 5-7 percent. SGD hardly moved following the news, as the currency has already been traded near its upper band and fully priced in a tendency of re-centring in October meeting. We continue to hold the opposite view, seeing limited scope for further gains in SGD.

Chart 3
Stock markets



Source: BBVA Research and Bloomberg

Chart 4
Foreign exchange markets



Source: BBVA Research and Bloomberg

Highlights

Who will pay the bill for China's 2008-09 fiscal stimulus?

One of the legacies of China's massive, infrastructure-led stimulus program of 2008-09 has been a build-up of local government debt. Our latest *Banking Watch* assesses the likely size of this debt and possible impact on bank balance sheets if some of the obligations, much of which were generated through local government financing vehicles (LGFVs), cannot be repaid. The topic is not new, but has been the focus of discussion in recent weeks in light of newly released government figures that raise questions about the true size of the debt and how it will be paid in the coming years. Official figures appear to put the size of local government debt between RMB 0.7-14.2 trillion (USD 1.6-2.2 trillion), equivalent to 27-36% of GDP. We believe the most accurate estimate lies at the upper end of the range, in line with other market estimates such as Moody's. Our main conclusion is that, although problem LGFV loans may generate a vast amount of new NPLs on bank balance sheets if not addressed, they appear manageable at a national level. We would not expect, however, banks to bear the full cost, as the most likely outcome would be a combination of government and banking sector involvement.

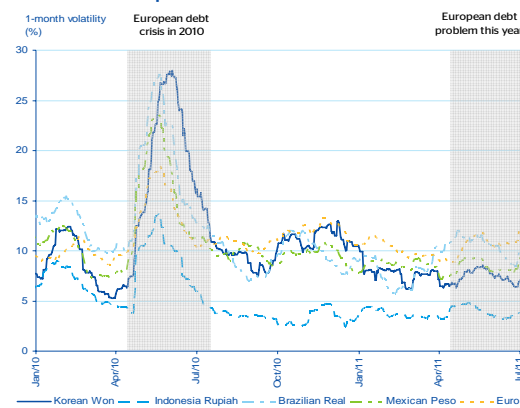
China signals plans to extend curbs on housing purchases to smaller cities

As noted in our *China Real Estate Outlook* published last week, the housing market has cooled over the past year under the influence of government tightening measures. At a national level, based on our estimates using official (NBS) data released this week, prices of residential properties increased 3.4% y/y in June, up slightly from 3.0% in May, but continuing a moderating trend since last year. However, for some time now, prices have been rising faster in smaller cities (Chart 6). Indeed, our report flagged that slower price increases to date and strong growth prospects in second and third tier cities, mean that the best investment opportunities lie in the smaller cities. To forestall price bubbles in these cities, the authorities have just signaled their intention to expand restrictions in the large cities to the smaller ones. Details have not yet been announced.

Strong economic fundamentals add appeal to Asian currencies

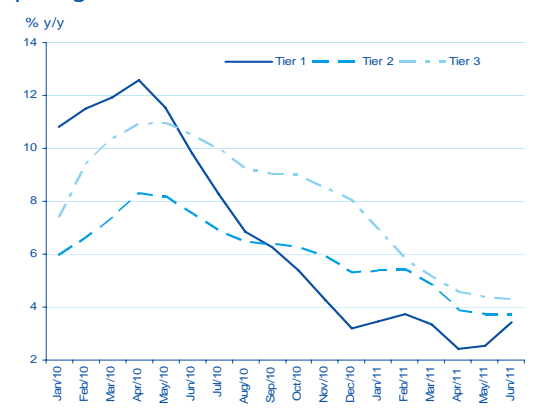
While concerns about debt contagion from European debt problems linger, recent fluctuations in currency markets suggest that markets hold a more sanguine view for the impact on the Asian region than they did when Greek debt concerns intensified in May 2010 (Chart 5). In particular, Asian exchange rates have exhibited extraordinary resilience compared to other global currencies. For example, exchange rate volatility of the Korean Won and Indonesian Rupiah, the region's two high beta currencies, have declined while that of the Euro have risen notably in recent months, a large contrast compared to events in 2010. Outside of Asia, currencies in other emerging markets seem to be following the same pattern. Confidence in the region's robust growth outlook and strong fundamentals, along with capital inflows attracted by relatively high yields could be the main factors for the resilience of Asian currencies. In contrast to the debt problems in the US and Europe, most Asian economies have sound fiscal positions, and low debt levels, along with well-capitalized banking systems and high reserves, making them least susceptible to contagion. These advantages have made Asian currencies appearing relatively safe.

Chart 5
Asian currencies have been more stable in this round of European debt shock



Source: BBVA Research and Bloomberg

Chart 6
China's smaller cities may see large housing price gains



Source: BBVA Research and Bloomberg

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Calendar Indicators

Australia	Date	Period	Prior	Cons.
Producer Price Index (YoY)	25-Jul	2Q	2.90%	--
Consumer Prices (YoY)	27-Jul	2Q	3.30%	3.40%
China	Date	Period	Prior	Cons.
Industrial Profits YTD YoY	27-Jul	JUN	27.90%	--
Hong Kong	Date	Period	Prior	Cons.
Exports YoY%	28-Jul	JUN	10.10%	--
Imports YoY%	28-Jul	JUN	13.00%	--
Japan	Date	Period	Prior	Cons.
Corp Service Price Index (YoY)	26-Jul	JUN	-0.90%	-0.80%
Retail Trade MoM SA	28-Jul	JUN	2.40%	1.00%
Overall Hhold Spending (YoY)	29-Jul	JUN	-1.90%	-2.80%
Jobless Rate	29-Jul	JUN	4.50%	4.60%
Natl CPI YoY	29-Jul	JUN	0.30%	0.20%
Industrial Production (MoM)	29-Jul	JUN P	6.20%	4.40%
Vehicle Production (YoY)	29-Jul	JUN	-30.90%	--
Housing Starts (YoY)	29-Jul	JUN	6.40%	3.70%
Philippines	Date	Period	Prior	Cons.
Total Imports (YoY)	26-Jul	MAY	20.30%	--
Singapore	Date	Period	Prior	Cons.
CPI (YoY)	25-Jul	JUN	4.50%	5.10%
Industrial Production MoM SA	26-Jul	JUN	-3.80%	3.50%
Unemployment Rate (sa)	29-Jul	2Q p	1.90%	--
Korea	Date	Period	Prior	Cons.
GDP at Constant Price (YoY)	27-Jul	2Q P	4.20%	3.80%
Industrial Production (MoM)	29-Jul	JUN	1.70%	--
Taiwan	Date	Period	Prior	Cons.
Industrial Production (YoY)	25-Jul	JUN	7.82%	6.70%
GDP - Constant Prices (YoY)	29-Jul	2Q P	6.55%	4.32%
Thailand	Date	Period	Prior	Cons.
Total Exports YOY%	29-Jul	JUN	17.30%	--
Total Imports YOY%	29-Jul	JUN	34.40%	--
Vietnam	Date	Period	Prior	Cons.
CPI (YoY)	25-29 JUL	JUL	20.80%	--

Indicator of the Week: Korean Q2 GDP growth (July 27)

Forecast: 3.5% y/y

Consensus: 3.8% y/y

Prior: 4.2% y/y

Comment: Korea's economic growth is likely to have slowed in Q2, as both exports and industrial production have moderated in recent months due to a combination of supply chain disruptions from Japan and high commodity prices. Last Friday the Bank of Korea also revised down its GDP outlook for 2011 to 4.3% from 4.5% previously, stressing that downside risks to growth have outweighed upside risks for the time being. Nevertheless, Korea has been relatively less affected by external headwinds given its strong export competitiveness, and we expect a gradual rebound in H2. For the whole year 2011, we expect the economy to expand 4.5%. Market impact: a lower-than-expected Q2 GDP growth could reduce expectations of interest rate hikes by the Bank of Korea.

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Calendar Events

India - India REPO Cutoff Yld, July 26

We expect a 25 bp rate hike in the benchmark repo rate.

Current	Expected
7.50%	7.75%

Philippines - Overnight Borrowing Rate, July 28

We expect a 25 bp hike in the overnight borrowing rate

Current	Expected
4.50%	4.50%

Markets Data

STOCK MARKETS	INDEX	Last price	% change over a week	Year to date	% Change over 1 Y
	China - Shanghai Comp.	2778.4	-15	-1.1	8.4
	Hong Kong - Hang Seng	22358.6	2.2	-2.9	8.6
	Taiwan - Weighted	8779.7	2.4	-2.1	14.5
	Japan - Nikkei 225	10106.0	1.3	-1.2	9.6
	Korea - Kospi	2161.2	0.7	5.4	24.5
	India - Sensex 30	18595.4	0.2	-9.3	2.7
	Australia - SPX/ASX 200	4609.5	3.0	-2.9	5.4
	Singapore - Strait Times	3169.0	2.7	-0.7	7.2
	Indonesia - Jakarta Comp	4092.0	1.7	10.5	36.0
	Thailand - SET	1116.2	3.4	8.1	34.0
	Malaysia - KLCI	1564.0	-0.8	3.0	17.1
	Philippines - Manila Comp.	4474.9	0.4	6.5	31.0

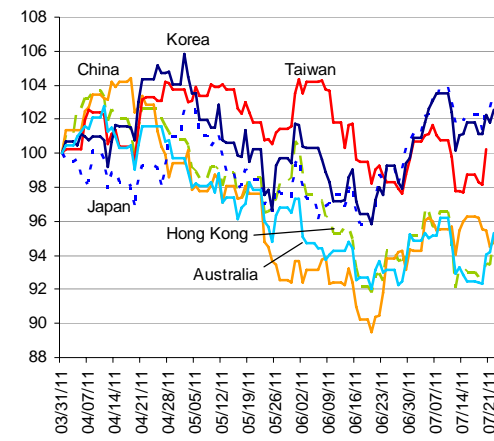
Last update: Friday, 11.15 Hong Kong time.

FOREIGN EXCHANGE MARKETS	CURRENCY	Spot	% change over a week	Forward 3-month	Forward 12-month
	China (CNY/USD)	6.45	0.26	6.43	6.38
	Hong Kong (HKD/USD)	7.79	0.03	7.8	8
	Taiwan (TWD/USD)	28.8	0.12	28.69	28.22
	Japan (JPY/USD)	78.6	0.69	78.5	78.2
	Korea (KRW/USD)	1051	0.69	1057.50	1070.58
	India (INR/USD)	44.4	0.30	44.9	46
	Australia (USD/AUD)	1.08	1.74	1	n.a.
	Singapore (SGD/USD)	1.21	0.75	1.21	1.2
	Indonesia (IDR/USD)	8529	0.18	8571	8833
	Thailand (THB/USD)	29.8	0.70	30.00	30.5
	Malaysia (MYR/USD)	2.98	0.80	3.0	3
	Philippines (PHP/USD)	42.4	1.20	42.59	42.88

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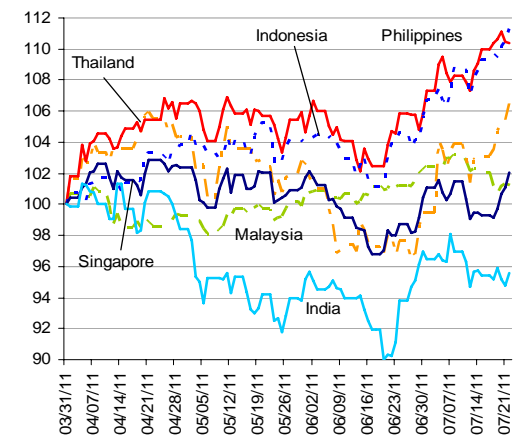
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Chart 7
Stock Markets



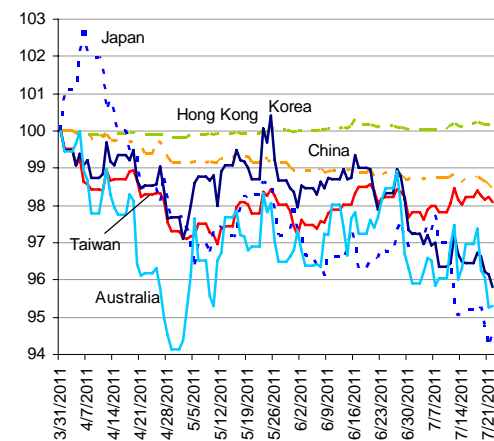
Source: BBVA Research and Bloomberg

Chart 8
Stock Markets



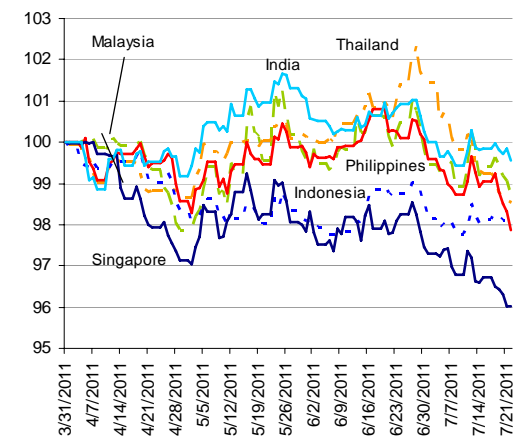
Source: BBVA Research and Bloomberg

Chart 9
Foreign Exchange Markets



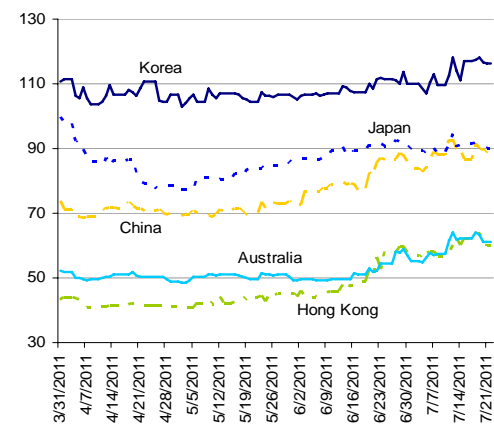
Source: BBVA Research and Bloomberg

Chart 10
Foreign Exchange Markets



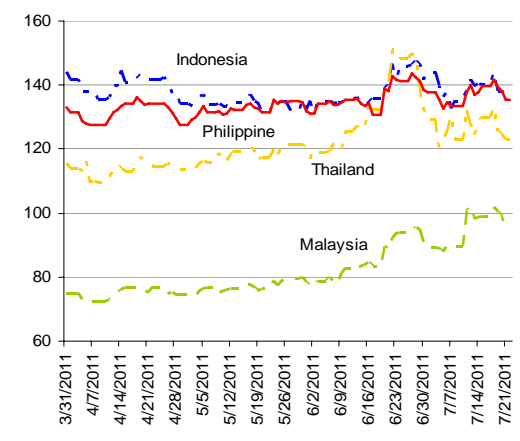
Source: BBVA Research and Bloomberg

Chart 11
Credit Default Swaps



Source: BBVA Research and Bloomberg

Chart 12
Credit Default Swaps



Source: BBVA Research and Bloomberg

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