

Weekly Watch

Asia

12 August 2011
Economic Analysis

Asia

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Bracing for downside risks to growth

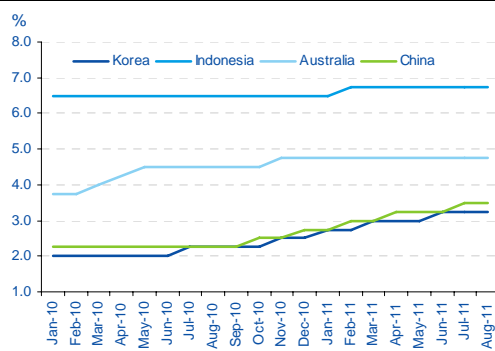
As global markets gyrate on worries about the US and European debt and growth outlooks, Asian investors are keeping a watchful eye on the region's external demand prospects and implications of further monetary easing in the US (see Markets). So far, the region's prospects remain bright, with recent export and activity indicators holding up surprisingly well. That said, a sharp deterioration in global growth or an intensification of financial instability abroad would have a detrimental growth impact on the region, especially for the smaller and more export-oriented economies ([Asia Outlook](#)). Fortunately, most of the region has policy room to cushion these effects, as already seen by central banks signaling a postponement of rate hikes (Chart 1 and Highlights). Notwithstanding downside risks to the global economy, we continue to expect a gradual rebound in Asia during the remainder of the year.

Robust activity indicators with rising inflation

Recent data releases point to surprisingly robust output and external demand. Exports for July in China and Taiwan surprised to the upside, resulting in a large trade surplus in China, which may be a factor for its willingness to allow currency appreciation (0.8% against the USD in the past week) in the midst of the global turmoil. Singapore saw an upward revision to its Q2 GDP (0.9% y/y; preliminary: 0.5%), and Q2 GDP in Hong Kong was robust at 5.1% y/y, albeit somewhat below expectations; meanwhile, industrial production for June unexpectedly accelerated in India (8.8% y/y; prior: 5.8%) and Malaysia (1.0% y/y; prior: -5.1%). In China, although July inflation was a little higher than expected, monthly activity indicators held up reasonably well (Highlights), helping bolster confidence that broader regional growth should stay on track. In the coming week, the focus will be on Japan's Q2 GDP and activity indicators (Weekly Indicator); India's release of July inflation, and GDP and trade data in Malaysia and Singapore, respectively.

Chart 1

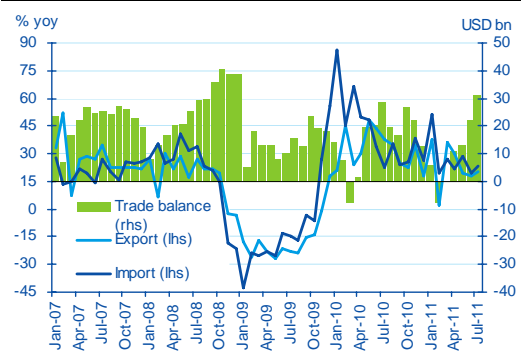
Interest rate hikes on hold for the time being



Source: BBVA Research and Bloomberg

Chart 2

China's July exports result in a large surplus



Source: BBVA Research and Bloomberg

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Highlights

Central banks slow monetary tightening amidst global financial turmoil

Despite inflationary pressures, interest rates are on hold against downside risks to growth

Q3 China Outlook: Growth moderating toward a soft landing

Our latest quarterly outlook for China sees a healthy moderating trend

Steady progress toward the internationalization of China's currency

New measures to allow remittances of RMB to the Mainland for FDI are welcome news

Economic Analysis

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Markets

Asian stocks have not been spared the volatility afflicting global markets from the S&P downgrade of the US, fears of a US slowdown, and sovereign debt worries in Europe. Most regional benchmark indices were stabilizing at end week, but still finished with deep losses. Asian FX, meanwhile, is trading mixed. Heightened risk aversion is causing appreciation pressure on the JPY, while any selloff of traditional risk-currencies is being limited by expectations of further monetary loosening in the US and by strong activity data in China, which bodes well as a buffer against global weakness. As such, most currencies ended the week within +/- 1% fluctuations against the USD.

In Bernanke we trust?

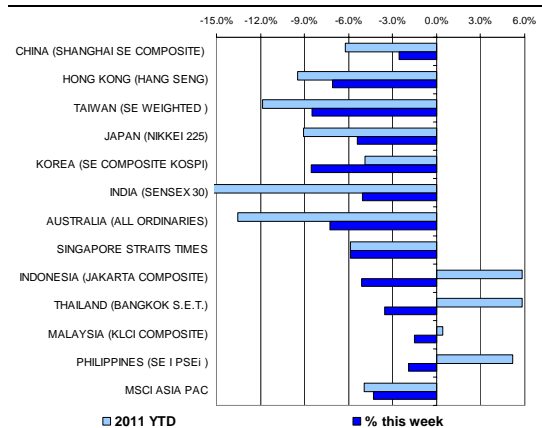
Market panic reflects a lack of confidence in global policymakers' ability to address rising prospects of a growth slowdown as the European debt crisis deepens. Worries were sparked by S&P's downgrade of US debt from AAA to AA+. While the downgrade has failed to provoke a major sell-off in US Treasuries, it highlights the constraints facing the US government in reviving the economy. On the monetary front, the FOMC meeting this week explicitly stated the Fed would keep rates low through mid-2013 and leave the door open to possible additional quantitative easing (QE). Moreover, opinions on the effectiveness of a third round of asset purchases are also polarizing the markets, but any move in this direction would likely weaken the USD, strengthen Asian FX and renew talks of "currency war".

In Europe, investors still question the ability of political leaders to prevent contagion. Following a G7 conference call last weekend, the European Central Bank (ECB) announced Monday to purchase Italian and Spanish debt to stem further rises in their bond yields and head off an important channel of contagion. That said, spillovers are continuing, and the focus has shifted to the stability of major French banks who are important holders of Greek debt. S&P's and Moody's affirmation of French sovereign rating Thursday has helped ease tensions for now, but confidence is still weak. Asian central banks and financial institutions are relatively less directly exposed to European debt, but they are still vulnerable to systemic risks in the global banking system.

Asian central banks pause in face of market turbulence

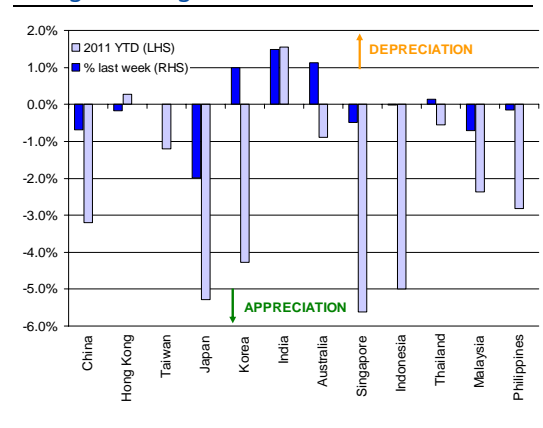
In light of market dislocation in past few weeks, and the possibility of global economic weakness, monetary authorities in Asia attach greater weight on growth rather than inflation in policy making and take a pause in rate hikes for now (see Highlights). As such, the Bank of Korea left its rates unchanged despite evidence of persistently high inflation, while China's State Council executive meeting held on August 9 just confirmed the objective of taming inflation and dropped the phase of "top priority". Bond markets quickly priced in a more pessimistic growth scenario, and see significant bull flattening across markets. In Australia, markets started to anticipate the RBA to cut rates as early as September, although that is not our call. AUDUSD has been mainly supported by attractive carry, the prospect of rate cuts are weighing on the pair. The surprised increase in the number of jobless this week may reinforce the downtrend in near term.

Chart 3
Stock markets



Source: BBVA Research and Bloomberg

Chart 4
Foreign exchange markets



Source: BBVA Research and Bloomberg

Highlights

Central banks slow monetary tightening amidst global financial turmoil

One of the region's responses to the deterioration in global prospects and financial volatility has been to slow the pace of monetary tightening. This was apparent this week as the Bank of Korea kept its policy rate unchanged at 3.25% for a second straight month despite July's higher-than-expected inflation outturn of 4.7% y/y (ahead of the BOK's 2%-4% inflation target). The BOK cited downside risks from, "the potential for continuing economic slowdown in major countries, the spread of sovereign debt problems in Europe, and international financial market unrest," but indicated that inflationary pressures are expected to continue, and that monetary policy would remain geared toward price stability going forward (hence our expectations of another rate hike before year-end). For its part, Indonesia also kept rates on hold this past week, citing declining inflation as the key reason. And finally, earlier this month the Reserve Bank of Australia kept its rates unchanged at 4.75% despite a higher-than-expected Q2 inflation outturn, as it cut its growth outlook and cited downside risks to the global economy; some market watchers even expect rate cuts in Australia before the year is out (a view we do not share). The authorities in China have also signaled their reluctance to tighten policy in the current global environment. Given our baseline of a gradual rebound in regional growth during the remainder of the year, we continue to anticipate modest rate hikes in the region.

Q3 China Outlook: Growth moderating toward a soft landing, despite risks

With uncertainties on the rise due to the weak outlook in the US and EU, the resilience of the Chinese economy is once again playing a crucial role in supporting regional and global growth prospects. In that context, our just-released quarterly [China Outlook](#) reviews recent developments and updates risks to the outlook. With growth having moderated in recent quarters, risks of overheating have diminished, although rising inflation remains a challenge. At the same time, our analysis suggests that, even with a slowdown in developed economies, a hard landing of the Chinese economy is unlikely given still-strong underlying growth momentum and room for fiscal and monetary policy to cushion an external shock to domestic growth. The moderation in GDP growth in China through the first half 2011 has been gradual, and mainly reflects the authorities' efforts to prevent the overheating. Indeed, indicators released this past week for July show that industrial output and exports are holding up well, with both either in line with or exceeding expectations. Inflation has risen well above expectations, reaching 6.5% y/y in July, mainly driven by food and commodity prices (Chart 5), but we expect it to moderate during the remainder of the year as tightening measures take effect and as commodity prices ease. An ongoing medium-term risk is the high level of local government debt, itself a legacy of the last stimulus package in 2008-09. However, the level of such debt still appears manageable and the authorities are taking early actions to contain it. With overheating risks easing and downside risks increasing, the policy tightening cycle of China appears to be nearing an end.

Steady progress toward the internationalization of China's currency

One of the impediments to China's efforts to accelerate the international use of its currency (RMB) has been restrictions on the use of offshore RMB, which make holding the currency less attractive. In this regard, a notable policy step was taken in mid-July by the People's Bank of China (PBoC) to allow foreign enterprises to remit offshore RMB to the Mainland for purposes of foreign direct investment (FDI). Previously, such flows had been allowed, but only on a case-by-case basis. The new policy will add more regularity, although it is still in a pilot form and excludes industries "under government monitoring and control" (such as the real estate sector given the authorities' tightening efforts). Nevertheless, it is expected to be expanded over time. China's efforts to internationalize the currency however, are being implemented at a gradual pace as the authorities do not want to open the capital account too fast. As an example, this month the PBoC tightened restrictions on domestic enterprises' borrowing through their subsidiaries in the RMB market for the purpose of bringing the funds back to the Mainland (although borrowing in USD is still permitted). This appears aimed at reducing capital inflows, as domestic firms have an incentive to borrow offshore at favorable interest rates. One measure of the growing size of the offshore RMB market is the size of deposits in Hong Kong, which have continued to grow sharply (Chart 6).

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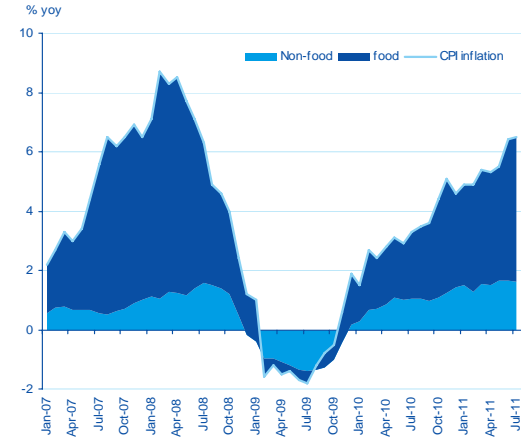
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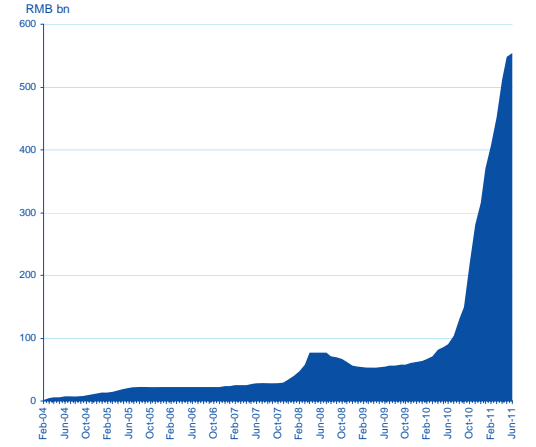
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Chart 5
China's inflation rises again on high food prices



Source: BBVA Research and Bloomberg

Chart 6
RMB deposits in Hong Kong are still rising



Source: BBVA Research and Bloomberg

Calendar Indicators

Australia	Date	Period	Prior	Cons.
New Motor Vehicle Sales YoY	15-Aug	JUL	-11.50%	--
Wage Cost Index YoY	17-Aug	2Q	3.80%	4.00%
Average Weekly Wages (YoY)	18-Aug	MAY	3.80%	4.00%
China	Date	Period	Prior	Cons.
Actual FDI (YoY)	12-15 AUG	JUL	2.80%	--
New Yuan Loans	12-15 AUG	JUL	633.9B	550.0B
Money Supply - M2 (YoY)	12-15 AUG	JUL	15.90%	15.80%
Hong Kong	Date	Period	Prior	Cons.
Unemployment Rate SA	18-Aug	JUL	3.50%	3.50%
India	Date	Period	Prior	Cons.
Monthly Wholesale Prices YoY%	16-Aug	JUL	9.44%	9.20%
Japan	Date	Period	Prior	Cons.
GDP Deflator YoY	15-Aug	2Q P	-1.90%	-1.70%
Nominal GDP (QoQ)	15-Aug	2Q P	-1.30%	-1.40%
GDP Annualized	15-Aug	2Q P	-3.50%	-2.50%
Nationwide Dept. Sales (YoY)	15-19 AUG	JUL	0.30%	--
Merchnds Trade Exports YoY	18-Aug	JUL	-1.6%	-1.8%
Merchnds Trade Imports YoY	18-Aug	JUL	9.8%	10.9%
All Industry Activity Index (MoM)	19-Aug	JUN	2.00%	2.20%
Malaysia	Date	Period	Prior	Cons.
CPI YoY	17-Aug	JUL	3.50%	3.60%
GDP YoY%	17-Aug	2Q	4.60%	3.80%
Philippines	Date	Period	Prior	Cons.
Overseas Remittances (YoY)	15-Aug	JUN	6.90%	--
Singapore	Date	Period	Prior	Cons.
Retail Sales Ex Auto (YoY)	15-Aug	JUN	8.30%	12.40%
Retail Sales (YoY)	15-Aug	JUN	10.00%	11.00%
Electronic Exports (YoY)	17-Aug	JUL	-17.20%	--
Non-oil Domestic Exports (YoY)	17-Aug	JUL	1.10%	4.80%
Non-oil Domestic Exp SA (MoM)	17-Aug	JUL	-4.50%	1.10%
Korea	Date	Period	Prior	Cons.
Department Store Sales YoY	17-19 AUG	JUL	8.20%	--
Discount Store Sales YoY	17-19 AUG	JUL	2.70%	--
Taiwan	Date	Period	Prior	Cons.
GDP - Constant Prices (YoY)	18-Aug	2Q F	4.88%	--
Current Account Balance (USD)	18-19 AUG	2Q	--	--
Export Orders (YoY)	19-Aug	JUL	9.18%	--

Indicator of the Week: Japan 2Q GDP growth (August 15)

Forecast: -0.7% q/q s.a.

Consensus: -0.7% q/q s.a.

Prior: -0.9% q/q s.a.

Comment: Q2 GDP data will reflect the full-quarter economic impact of the March 11 earthquake. First quarter GDP was weaker than expected, but this mainly reflected sluggish activity prior to the quake. Most activity indicators point to a steep decline in production and exports in March/April, with a rebound beginning in May as supply chain disruptions eased. As a result, Q2 GDP growth is expected to have contracted for a third consecutive quarter, although we expect a rebound in the second half year. Market impact: A slower-than-expected reading, especially beyond that which can be explained by disruptions from the earthquake, could intensify concerns of global weakness and could dampen sentiment.

Calendar Events

Australia - Reserve Bank's Board August Minutes, August 16

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STOCK MARKETS	INDEX	Last price	% change over a week	Year to date	% Change over 1 Y
	China - Shanghai Comp.		-1.0	-7.4	0.9
	Hong Kong - Hang Seng	19933.4	-4.8	-13.5	-5.6
	Taiwan - Weighted	7775.0	-1.0	-13.3	-0.7
	Japan - Nikkei 225	8997.6	-3.3	-12.0	-2.3
	Korea - Kospi	1835.9	-5.6	-10.5	6.6
	India - Sensex 30	17059.4	-1.4	-16.8	-5.6
	Australia - SPX/ASX 200	4196.5	2.2	-11.6	-4.6
	Singapore - Strait Times	2846.8	-4.9	-10.8	-2.7
	Indonesia - Jakarta Comp	3869.4	-1.3	4.5	27.9
	Thailand - SET	1062.1	-2.9	2.8	23.2
	Malaysia - KLCI	1487.4	-2.4	-2.1	10.2
	Philippines - Manila Comp.	4352.6	-1.9	3.6	25.0

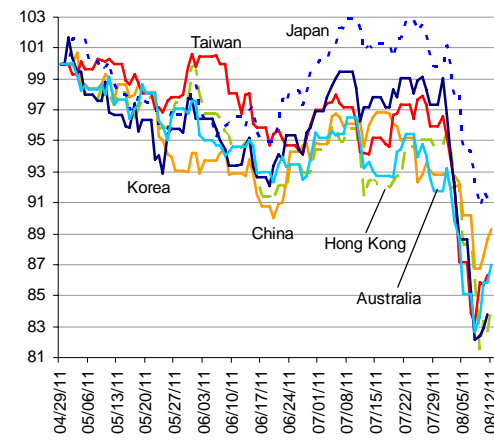
Last update: Friday, 11.15 Hong Kong time.

FOREIGN EXCHANGE MARKETS	CURRENCY	Spot	% change over a week	Forward 3-month	Forward 12-month
	China (CNY/USD)	6.40	0.71	6.36	6.27
	Hong Kong (HKD/USD)	7.79	0.17	7.8	8
	Taiwan (TWD/USD)	28.9	-0.01	28.70	28.29
	Japan (JPY/USD)	76.8	2.03	76.7	76.3
	Korea (KRW/USD)	1078	-0.98	1083.10	1088.20
	India (INR/USD)	45.4	-1.87	45.5	46
	Australia (USD/AUD)	1.03	-1.12	1	n.a.
	Singapore (SGD/USD)	1.21	0.48	1.21	1.2
	Indonesia (IDR/USD)	8546	0.02	8620	8840
	Thailand (THB/USD)	29.9	-0.13	30.01	30.3
	Malaysia (MYR/USD)	2.99	0.72	3.0	3
	Philippines (PHP/USD)	42.6	0.16	42.45	42.55

Last update: Friday, 11.15 Hong Kong time.

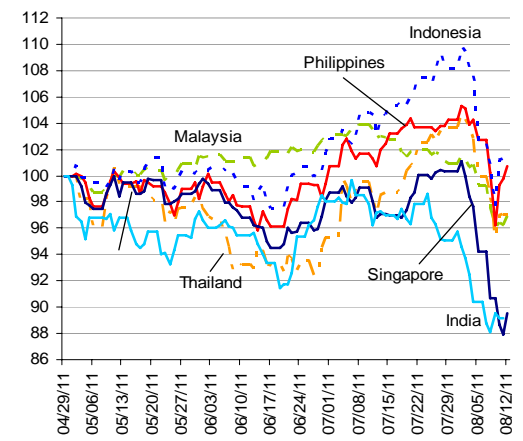
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Chart 7
Stock Markets



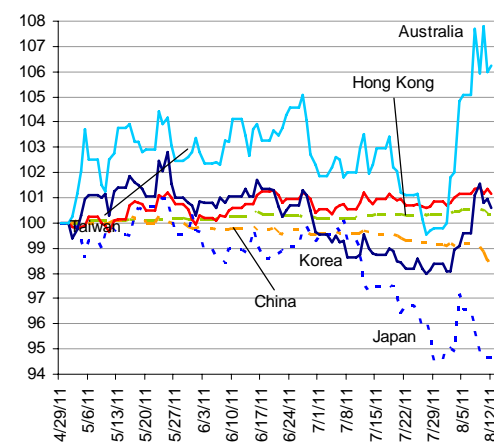
Source: BBVA Research and Bloomberg

Chart 8
Stock Markets



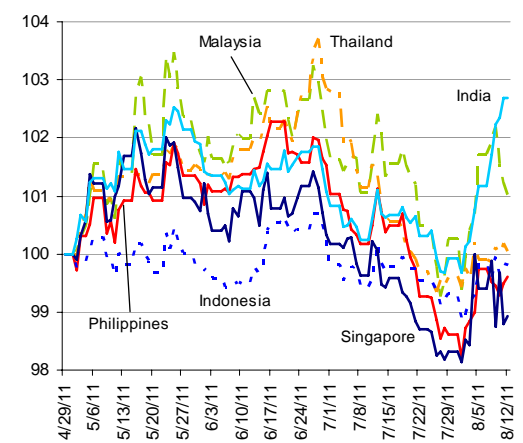
Source: BBVA Research and Bloomberg

Chart 9
Foreign Exchange Markets



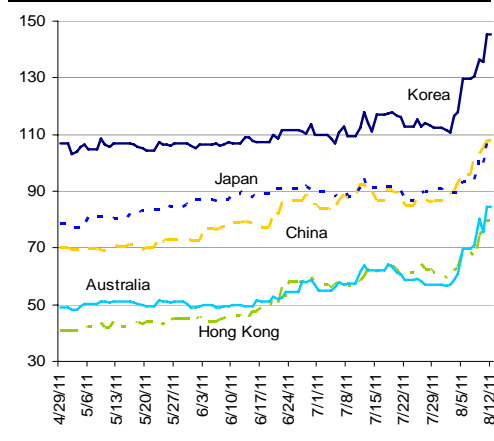
Source: BBVA Research and Bloomberg

Chart 10
Foreign Exchange Markets



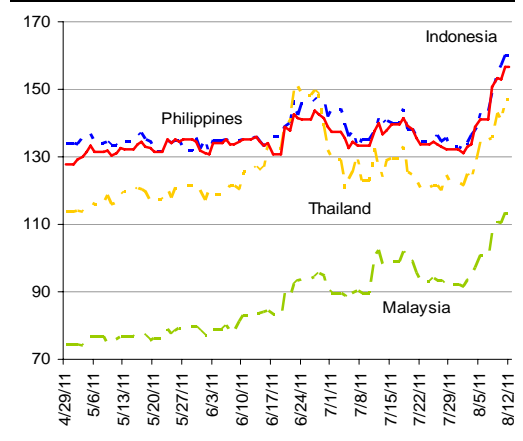
Source: BBVA Research and Bloomberg

Chart 11
Credit Default Swaps



Source: BBVA Research and Bloomberg

Chart 12
Credit Default Swaps



Source: BBVA Research and Bloomberg

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