

# Weekly Watch

## Asia

30 September 2011  
Economic Analysis

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## Asian growth holds up, but for how long?

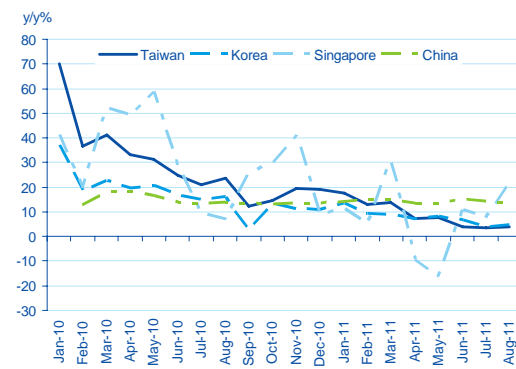
Regional markets continue to be buffeted by swings in global sentiment towards the US growth outlook and prospects of a resolution of the European debt crisis. Asian markets finished up for the week on hopes of passage of a broadened European Financial Stability Facility (EFSF), but then ended on a whimper due to growth concerns (see Markets). In Hong Kong markets closed sharply lower, possibly due to reverberations from reports of US Justice Department investigations of the accounting practices of Chinese companies listed overseas, as well as lingering concerns about the regional growth outlook. With respect to the latter, signs of resilience could be found in today's release of China's HSBC PMI which was not as bad as had been feared (it comes just ahead of the release of the official PMI index; see our last [Weekly Indicator](#)). Nevertheless, regional growth is moderating, with industrial production weakening in Japan and Korea, along with lower exports in Hong Kong and Thailand (see below).

### Production and exports show signs of weakening

Industrial production released today disappointed in Japan (0.8% m/m for August; consensus: 1.5%) (Chart 2 and Highlights) and in Korea (-1.9% m/m; consensus: -0.3%), despite a better-than-expected outturn for Singapore released earlier in the week (3.9% m/m; consensus: -4.5%). Meanwhile, export growth is easing in Hong Kong, where the August outturn came in below expectations (6.8% y/y; consensus: 7.5%), as well as in Thailand.

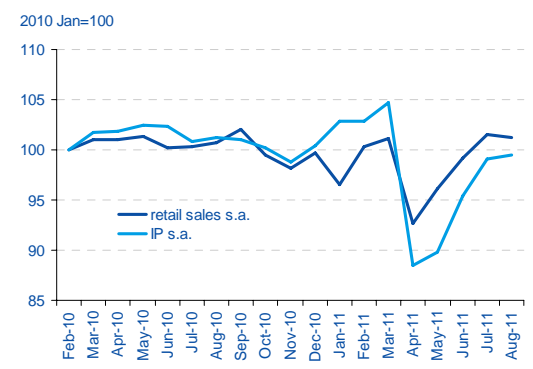
In the coming week, Australia and Japan will hold monetary policy meetings, with no changes expected. Korea will release the region's first trade figures for September (see Weekly indicator). Also, September inflation will be released in Korea, Indonesia, Taiwan, Thailand and the Philippines (see Calendar).

Chart 1  
**Industrial production is weakening in the region**



Source: Bloomberg and BBVA Research

Chart 2  
**Japan's recovery is at risk.**



Source: Bloomberg and BBVA Research

## Highlights

### Unusual volatility in RMB offshore FX market

Despite a steep depreciation in the offshore rate, gradual currency appreciation should continue

### Japan sets reconstruction budget amidst external risks to recovery

Reconstruction spending should sustain the recovery, despite signs of weakening demand

### Inflation eases in Vietnam, but remains high amidst conflicting policy signals

Inflation finally eases as the authorities struggle to maintain macro stability

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# Markets

## Waiting on a resolution from Europe

Asian equity markets have responded with a gentle move upwards this week as Europe appears to be inching towards a bailout fund, but this could simply be a breather after a terrible prior week. Asian sovereign CDS spreads are continuing to widen on external demand concerns, regardless of strong regional fundamentals. While Asian central banks have signaled they are well aware of global risks and stand ready to provide support if necessary, presently the markets are more concerned with finding out what additional measures will be implemented by the EU in order to stabilize the ongoing situation regarding Greece. These further measures may include leveraging the EFSF, increasing the haircut on Greek debt and/or creating a safety net for European banks.

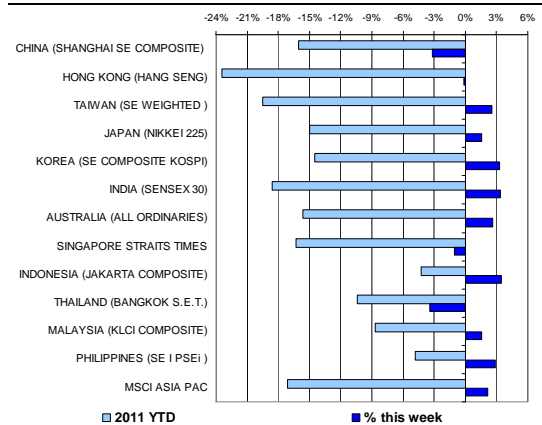
## Asian currencies stabilize, but cautious central banks limit scope for rebound

Asian currencies have stabilized in the absence of negative headlines from Europe, but sentiment remains fragile. Markets are clearly worried that the global economy is heading into recession, which would dim the outlook for the region's exports and could eventually prompt Asian central banks to cut rates. Most central banks in Asia are continuing to express concerns about global uncertainties, with attention clearly placed on growth over inflation. Korea's finance minister said inflation in September seemed to have moderated, while industrial output for August slid 1.9% m/m and surprised to the downside. The Bank of Thailand raised rates in August, but recently its governor shifted to a neutral stance, as did the governor of the BSP in the Philippines, who stated that the Bank may leave interest rates unchanged for the rest of the year. Bank Indonesia was among the most dovish in the region, as its director of monetary policy and research in a remark said "there is room to lower the benchmark rate" and the Bank stands ready to cut rates to boost growth. Finally, the Taiwan central bank was the latest EM country this week to adopt a neutral policy stance, leaving rates steady at 1.875%. Rising risks of an abrupt growth slowdown should continue to limit the upside of Asian FX in the near term.

## Holding pattern in Asian markets

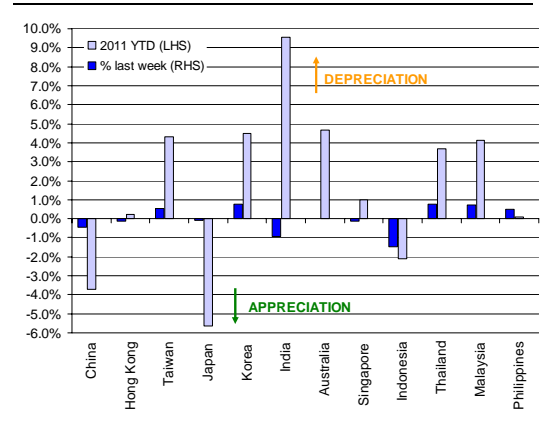
The MSCI Asia Index rose over 2.5% from last week. This week's activity is a continuation of a broader pattern in which markets appear to be gyrating weekly given worries about the situation in Europe and the global economy. The general sentiment remains tilted towards an avoidance of sustained risk-taking by investors. A clear sign of this is in new issuance, which has dried up in both the IPO and bond markets as investors are showing decreased demand for new issues given global uncertainties. Bond markets have been under stress, Indonesia's and China's in particular. Chinese property companies such as Evergrande and Country Garden are weaker on fears that Chinese bank regulators will restrict their access to funding. We continue to expect regional markets to be concerned with risks to the downside.

Chart 3  
Stock markets



Source: BBVA Research and Bloomberg

Chart 4  
Foreign exchange markets



Source: BBVA Research and Bloomberg

## Highlights

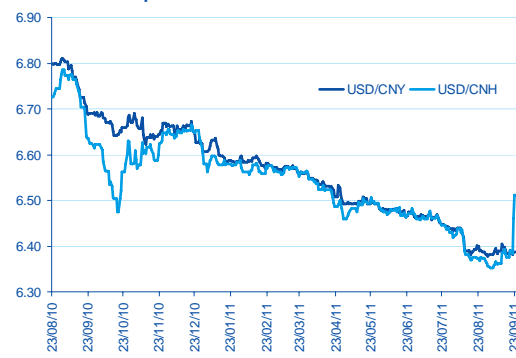
### Unusual volatility in RMB offshore FX market

The Chinese currency fell sharply this past week against the USD in offshore markets (known as the CNH). The offshore exchange rate reached a five-month peak (depreciation) of 6.512 on September 23, causing an unusually wide gap with the official onshore rate (CNY), and marking the first time since the creation of the offshore market in August 2010 that the offshore rate has traded at a discount (more depreciated) vis-à-vis the onshore rate for a sustained basis. At the same time, the offshore non-deliverable market (NDF) started pricing in a mild depreciation in the one to twelve-month tenors. Meanwhile, in a sign that the authorities plan to continue their gradual appreciation of the currency, in the onshore market they continued setting the daily fixing rates at appreciated levels, although intraday trading caused the rate to move to the more depreciated end of the band (the rate is allowed to trade in a daily band of +/- 0.5% around the daily fixing).

The sudden weakness in offshore CNH trading reflects a sell off among portfolio managers who are closing emerging market positions to meet possible redemption needs. As a result, RMB-denominated bonds in the offshore market ("Dim Sum bonds") followed broader emerging market trends with a significant sell off and widening of credit spreads. Adding to the selling pressure, some investors may have started questioning whether the PBoC will maintain its currency appreciation policy in light of weakening global activity and deepening worries over European debt issues, which have resulted in sharp rises in the USD against other Asian currencies. (On an important technical note, the Bank of China, the sole designated CNY clearing bank in Hong Kong, exhausted its quarterly quota with the PBoC and suspended CNH purchases, further exacerbating the weakness of the currency in offshore markets).

We believe the currency volatility is temporary. The authorities are delivering a strong message of their intention to maintain a gradual appreciation policy. Indeed, just a week ago, the PBoC's Governor, Mr. Zhou Xiaochuan, reiterated that China would not change its "overall policy tone." Accordingly, as noted above, the PBOC has been aggressively setting CNY fixing rates at appreciated levels since last Friday. We are maintaining our baseline end-2011 and end-2012 targets for USDCNY at 6.300 and 6.00 respectively. We also believe the differentials between offshore USDCNH and onshore USDCNY will likely narrow in October when the BOC's new quota is reinstated. Markets are continuing to speculate, however, that the authorities may eventually widen the daily trading band, which could result in a higher degree of daily two-way volatility than in the past.

Chart 5  
An unusual spike in offshore RMB (CNH) rates...



Source: BBVA Research and Bloomberg

Chart 6  
...causes the offshore CNH to trade at a discount



Source: BBVA Research and Bloomberg

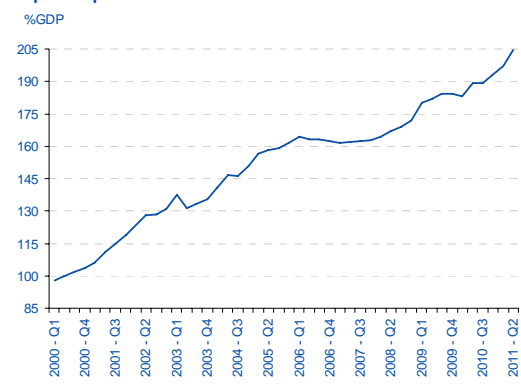
### Japan sets reconstruction budget amidst external risks to recovery

As Japan's economy continues to recover from the March 11 quake and tsunami, activity indicators over the past week underscored risks to the outlook. In particular, industrial production for August rose by a slower-than-expected 0.8% m/m s.a. (consensus: 1.5%). Meanwhile, retail sales registered a surprising fall for the month of -1.7% m/m s.a. Data released earlier this month also showed that August exports rose by less than expected (2.8% y/y vs. consensus: 8.0% y/y). The

weak export data added to evidence that the global slowdown, European debt crisis, and the strong yen (which has appreciated due to its safe haven characteristics) have weighed on recovery prospects. Despite these downside risks, we remain optimistic that the economy will continue to recover during the remainder of the year, boosted by the post-quake rebuilding. For 2011 as a whole, we project GDP to contract by -0.3% in 2011, and to expand by 2.9% in 2012.

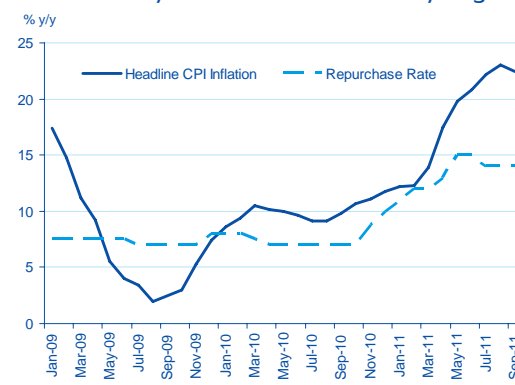
Meanwhile, the past week was busy for the Japanese government and the ruling-Democratic Party (DPJ), who have agreed to a third supplementary budget of 12 trillion yen (\$156 billion) for the post-quake reconstruction. (The first supplementary budget of 4 trillion yen was passed on May 2, and the second one of 2 trillion yen on July 25.) Adding up all three budgets, the government's post-quake reconstruction in the next 5 years will total 18 trillion yen, about 3.8% of GDP. The third budget is expected to be sent to the parliament for approval in October. To help finance this spending, given the limited scope for further debt issuance in view of Japan's already high debt-to-GDP ratio, a temporary tax hike plan was unveiled. Under the plan, the government will collect non-tax revenue of 7 trillion yen by selling shares of Japan Tobacco and energy-related accounts; the individual income tax is to be raised for 10 years starting in January 2013 and corporate tax for three years starting next April; they also call for increases in tobacco and local taxes. The government is planning to issue special bonds of 10+ years maturity to fund the third extra budget. Plans are also underway for a fourth supplementary budget of 1-2 trillion yen, recourse to new bond issuance.

Chart 7  
Japan's public debt exceeds 200% of GDP...



Source: CEIC and BBVA Research

Chart 8  
Inflation finally eases in Vietnam but stays high



Source: CEIC and BBVA Research

**Inflation eases in Vietnam, but remains high amidst conflicting policy signals**

For over a year now, Vietnam has been struggling to maintain macro stability in the face of an overheating economy. Even as prospects for the global economy are becoming less certain, for the first time in quite a while, there are signs that pressures in Vietnam may be easing. For example, inflation is finally showing signs of easing and, although still very high - at 22.4% in September (from 23.0% in August) -- by far the highest in Asia - markets have reacted positively, with a fall in bond yields to a three-month low. Nevertheless, the authorities have been confusing markets with some of their policy actions. For example, in the past week the State Bank of Vietnam (the central bank) increased the repo term to aid liquidity, the latest monetary policy move in support of economic growth since late August, while on the other hand Vietnam's government said it will further restrain lending growth and cut money supply expansion as it seeks to curb inflation. These moves add to the ones made a few months ago, when the Central Bank unexpectedly cut interest rates while inflation was soaring. Under this framework, we project inflation to remain high, at around 17-20% y/y through the end of the year. We project GDP growth will continue its upside trend and reach 6.2% for 2011.

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## Calendar Indicators

| <b>Australia</b>            | <b>Date</b> | <b>Period</b> | <b>Prior</b> | <b>Cons.</b> |
|-----------------------------|-------------|---------------|--------------|--------------|
| Building Approvals (MoM)    | 4-Oct       | AUG           | 1.00%        | 0.60%        |
| Retail Sales s.a. (MoM)     | 5-Oct       | AUG           | 0.50%        | 0.20%        |
| <b>China</b>                | <b>Date</b> | <b>Period</b> | <b>Prior</b> | <b>Cons.</b> |
| PMI Manufacturing           | 1-Oct       | SEP           | 50.9         | 51.1         |
| China Non-manufacturing PMI | 3-Oct       | SEP           | 57.6         | --           |
| <b>Indonesia</b>            | <b>Date</b> | <b>Period</b> | <b>Prior</b> | <b>Cons.</b> |
| CPI Inflation (YoY)         | 3-Oct       | SEP           | 4.79%        | 4.88%        |
| Core Inflation (YoY)        | 3-Oct       | SEP           | 5.15%        | 4.98%        |
| Exports (YoY)               | 3-Oct       | AUG           | 39.50%       | 28.90%       |
| Imports (YoY)               | 3-Oct       | AUG           | 27.20%       | 28.40%       |
| <b>India</b>                | <b>Date</b> | <b>Period</b> | <b>Prior</b> | <b>Cons.</b> |
| Exports (YoY)               | 3-Oct       | AUG           | 81.80%       | --           |
| Imports (YoY)               | 3-Oct       | AUG           | 51.50%       | --           |
| <b>Malaysia</b>             | <b>Date</b> | <b>Period</b> | <b>Prior</b> | <b>Cons.</b> |
| Exports (YoY)               | 6-Oct       | AUG           | 7.10%        | 7.70%        |
| Imports (YoY)               | 6-Oct       | AUG           | 2.90%        | 6.20%        |
| <b>Philippines</b>          | <b>Date</b> | <b>Period</b> | <b>Prior</b> | <b>Cons.</b> |
| CPI Inflation (YoY)         | 5-Oct       | SEP           | 4.70%        | 4.90%        |
| Core CPI (YoY)              | 5-Oct       | SEP           | 3.40%        | --           |
| <b>Korea</b>                | <b>Date</b> | <b>Period</b> | <b>Prior</b> | <b>Cons.</b> |
| Exports (YoY)               | 1-Oct       | SEP           | 27.10%       | 16.60%       |
| Imports (YoY)               | 1-Oct       | SEP           | 29.20%       | 28.50%       |
| CPI Inflation (YoY)         | 4-Oct       | SEP           | 5.30%        | 4.50%        |
| Core CPI (YoY)              | 4-Oct       | SEP           | 4.00%        | --           |
| South Korea FDI (YoY)       | 4-6 OCT     | 3Q            | 20.3         | --           |
| <b>Thailand</b>             | <b>Date</b> | <b>Period</b> | <b>Prior</b> | <b>Cons.</b> |
| CPI Inflation (YoY)         | 5-Oct       | SEP           | 1.34%        | 1.40%        |
| WPI (YoY)                   | 5-Oct       | SEP           | 3.85%        | 3.62%        |
| Exports (YoY)               | 7-Oct       | SEP           | 7.20%        | 10.30%       |
| Imports (YoY)               | 7-Oct       | SEP           | 6.40%        | 8.90%        |
| <b>Thailand</b>             | <b>Date</b> | <b>Period</b> | <b>Prior</b> | <b>Cons.</b> |
| CPI Inflation (YoY)         | 3-Oct       | SEP           | 4.29%        | 3.90%        |
| Core CPI (YoY)              | 3-Oct       | SEP           | 2.85%        | 2.90%        |

### Indicator of the Week: Korean exports for September (October 1)

**Forecast: 27.6% y/y**      **Consensus: 16.6% y/y**      **Prior: 25.9% y/y**

Comment: Korean exports are the first monthly release for the region and closely watched as a bellwether given Korea's important place in global supply chains. Exports from Korea have so far have been relatively resilient, with demand from emerging markets offsetting weaker demand in developed economies. Going forward, we expect export trends to soften due to the global slowdown, although in year-on-year terms for September exports should hold up well due to base effects. Also, the won's recent weakening should help exporters to maintain their competitive edge. Market Impact: A lower than expected outturn could weaken sentiment about Asia's growth outlook and in the short turn could lead to further currency weakness in Korea and the region.

## Calendar Events

### Australia - RBA Cash Target, October 4

We expect no change in the target rate.

|                |                  |
|----------------|------------------|
| <b>Current</b> | <b>Consensus</b> |
| 4.75%          | 4.75%            |

### Japan - BOJ Target Rate, October 7

We expect no change in the target rate.

|                |                  |
|----------------|------------------|
| <b>Current</b> | <b>Consensus</b> |
| 0.10%          | 0.10%            |

## Markets Data

| STOCK MARKETS | INDEX                      | Last price | % change over a week | Year to date | % Change over 1 Y |
|---------------|----------------------------|------------|----------------------|--------------|-------------------|
|               | China - Shanghai Comp.     | 2356.5     | -3.2                 | -16.1        | -11.3             |
|               | Hong Kong - Hang Seng      | 17636.5    | -0.2                 | -23.4        | -21.2             |
|               | Taiwan - Weighted          | 7227.1     | 2.6                  | -19.5        | -12.3             |
|               | Japan - Nikkei 225         | 8691.6     | 1.5                  | -15.0        | -7.2              |
|               | Korea - Kospi              | 1754.4     | 3.4                  | -14.5        | -6.3              |
|               | India - Sensex 30          | 16700.1    | 3.3                  | -18.6        | -16.8             |
|               | Australia - SPX/ASX 200    | 4004.8     | 2.6                  | -15.6        | -12.6             |
|               | Singapore - Strait Times   | 2671.7     | -1.0                 | -16.3        | -13.8             |
|               | Indonesia - Jakarta Comp   | 3545.9     | 3.5                  | -4.3         | 1.3               |
|               | Thailand - SET             | 925.1      | -3.5                 | -10.4        | -5.2              |
|               | Malaysia - KLCI            | 1387.7     | 1.6                  | -8.6         | -5.2              |
|               | Philippines - Manila Comp. | 3999.7     | 2.9                  | -4.8         | -2.4              |

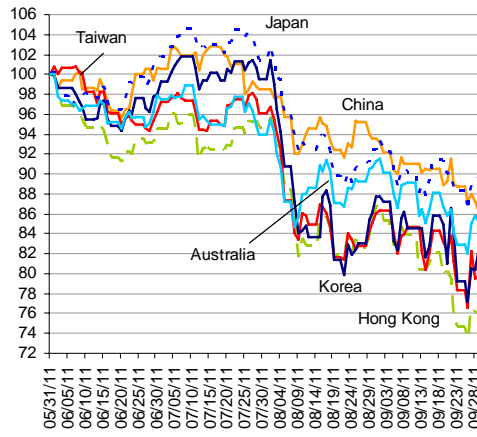
Last update: Friday, 11.45 Hong Kong time.

| FOREIGN EXCHANGE MARKETS | CURRENCY              | Spot | % change over a week | Forward 3-month | Forward 12-month |
|--------------------------|-----------------------|------|----------------------|-----------------|------------------|
|                          | China (CNY/USD)       | 6.36 | 0.44                 | 6.41            | 6.44             |
|                          | Hong Kong (HKD/USD)   | 7.79 | 0.14                 | 7.78            | 7.76             |
|                          | Taiwan (TWD/USD)      | 30.6 | -0.52                | 30.49           | 30.12            |
|                          | Japan (JPY/USD)       | 76.6 | 0.08                 | 76.45           | 76.03            |
|                          | Korea (KRW/USD)       | 1176 | -0.76                | 1182            | 1181             |
|                          | India (INR/USD)       | 49.0 | 1.23                 | 49.76           | 50.82            |
|                          | Australia (USD/AUD)   | 0.98 | -0.01                | 1.03            | n.a.             |
|                          | Singapore (SGD/USD)   | 1.30 | 0.15                 | 1.30            | 1.29             |
|                          | Indonesia (IDR/USD)   | 8808 | 1.51                 | 9360            | 9650             |
|                          | Thailand (THB/USD)    | 31.2 | -0.77                | 31.37           | 31.86            |
|                          | Malaysia (MYR/USD)    | 3.19 | -0.71                | 3.21            | 3.23             |
|                          | Philippines (PHP/USD) | 43.8 | -0.51                | 43.96           | 44.10            |

Last update: Friday, 11.45 Hong Kong time.

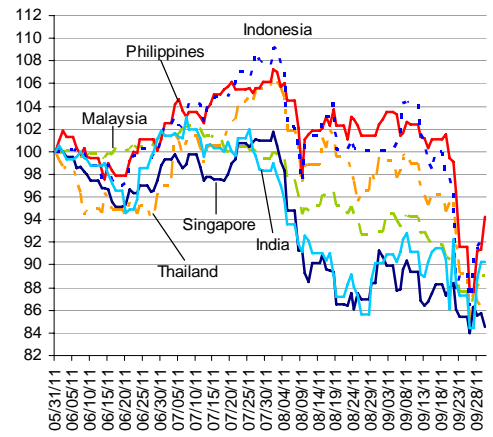
Charts

Chart 9  
Stock Markets



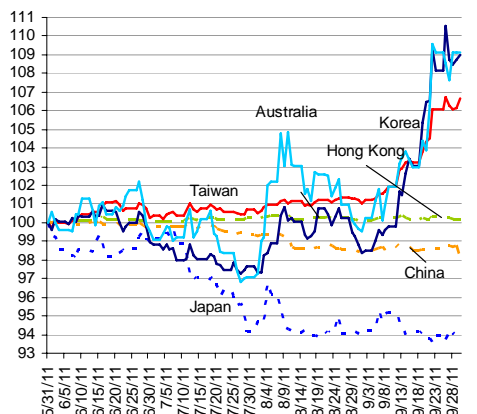
Source: BBVA Research and Bloomberg

Chart 10  
Stock Markets



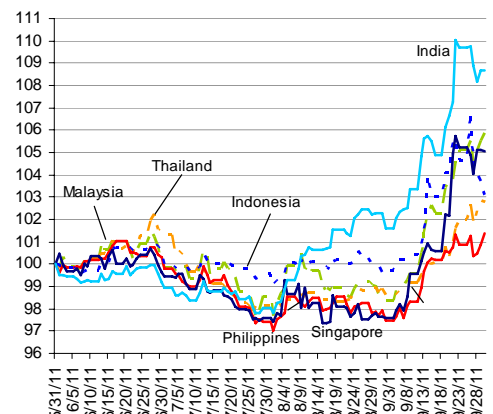
Source: BBVA Research and Bloomberg

Chart 11  
Foreign Exchange Markets



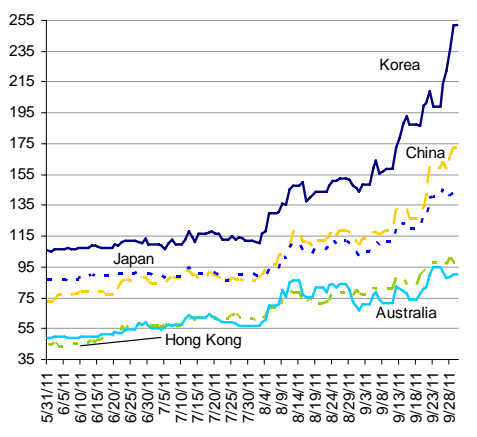
Source: BBVA Research and Bloomberg

Chart 12  
Foreign Exchange Markets



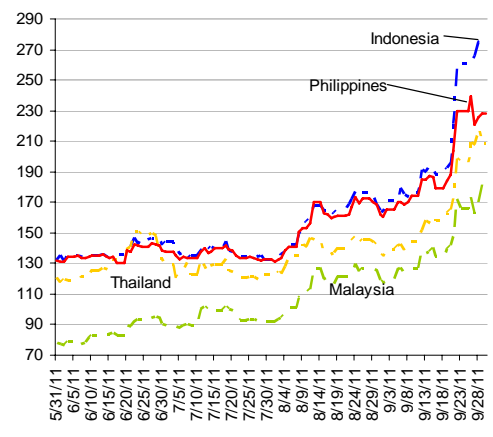
Source: BBVA Research and Bloomberg

Chart 13  
Credit Default Swaps



Source: BBVA Research and Bloomberg

Chart 14  
Credit Default Swaps



Source: BBVA Research and Bloomberg



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