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Weekly Watch

Asia

25 November 2011
Economic Analysis

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Keeping an eye on Asia's strengths

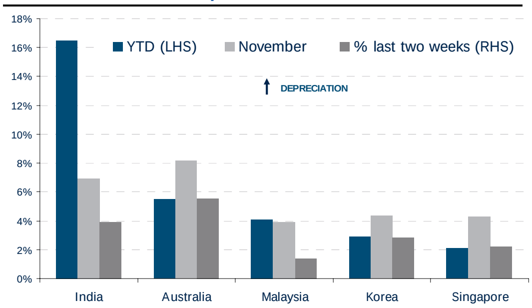
It is becoming an all too familiar refrain, that Asian markets are held hostage to developments in Europe. That is the case once again this week, with both currency (Chart 1) and equity markets falling in tandem with global trends. The declines reflect not only global risk aversion, but also real economic spillovers to the region as growth and exports gradually weaken. China's flash (private sector) PMI provided further evidence, moving into contraction zone at 48.0. However, there are some positive signs. We expect next week's official PMI to stay in the expansion zone (Weekly Indicator), in line with our soft landing outlook as the authorities fine tune monetary policy through selected cuts in required reserve ratios. In Hong Kong and Taiwan, exports and export orders, respectively, surprised to the upside. Elsewhere, Vietnam's government appears to be taking steps to strengthen its policy framework through market-oriented reforms including sales of stakes in public enterprises, as well as greater transparency. In short, while the region is feeling the effects of external spillovers, in some respects prospects are relatively good. Indeed, the region received attention at last week's APEC meeting in a sign of its strong prospects (see Highlights).

Inflation easing, but slowly

Inflation is clearly receding in most of the region's economies, but remains somewhat sticky in others for October (Chart 2), such as Hong Kong, (5.8% y/y; consensus: 5.7%) and Singapore (5.4% y/y; consensus: 5.2%) due to still-high housing costs, and in Malaysia (3.4% y/y; consensus: 3.3%). In Vietnam, which is struggling to maintain macro stability, inflation eased further for November, but from very high levels (19.8% y/y; prior: 21.6%). At the other end of the spectrum, Japan slipped again into deflation as expected (-0.2% y/y; consensus: -0.1%). As noted above, Taiwan's October export orders surprised to the upside (4.4% y/y; consensus: 3.5%; BBVA: 4.2%), while in Hong Kong exports picked up (11.5% y/y; consensus: 1.9%), reversing September's -3.0% y/y plunge.

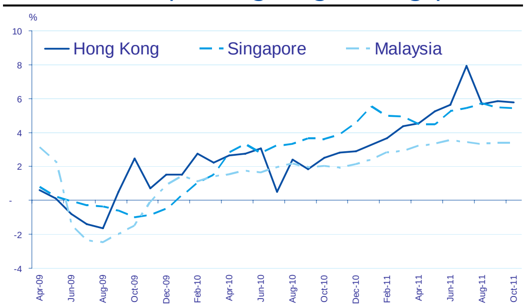
Next week will bring a set of November inflation data for Korea, Indonesia and Thailand. The main focus will be on China's PMI (Weekly Indicator). Korea's November exports will be closely watched for more signs of the external demand picture. Meanwhile, India and the Philippines will post their third quarter GDP outturns. Monetary policy meetings are scheduled in Thailand and the Philippines. We expect a 25 bp interest rate cut in Thailand.

Chart 1
Asian currencies depreciate



Source: Bloomberg and BBVA Research

Chart 2
Inflation is sticky in Hong Kong and Singapore



Source: Bloomberg and BBVA Research

Highlights

China's shadow bank lending: assessing the risks to financial stability

Our latest Banking Watch sees risks from rapid lending growth, but they are still manageable

Trans-Pacific Partnership seeks to expand trade

China's exclusion from the planned trade agreement could help to spur domestic reforms

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Markets

Indian rupee's slide highlights deteriorating sentiment

Asian markets are continuing their slide on bearish developments in Europe and the US. The poor German bond auction on Wednesday shows the European market is in a fragile psychological state. US third quarter GDP was revised downwards to 2.0% from 2.5%, and the US 'supercommittee' failed to agree on $1.2 trillion in savings it was tasked to find, which leaves market participants with a lack of confidence in policymakers' ability to reign in record deficits. Regionally, the rupee continues to sell off, which is causing the Reserve Bank of India to intervene in FX markets and also pass measures geared to increase the supply of dollars to stem the rupee's slide. Also, S&P has warned that future downgrades for Japan may be on the horizon as the government struggles to rein in its finances.

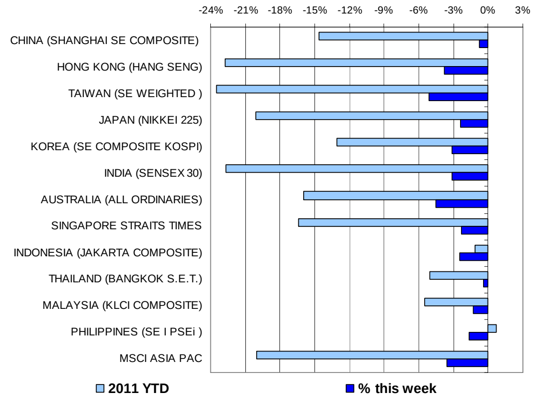
FX markets show signs of spillovers from Europe

Asian currencies sold off sharply this week as FX markets sense that in Europe no solution is imminent. The Aussie dollar broke below 0.97/USD after beginning the week at parity, and the Singapore dollar weakened past $1.31/USD, but the primary focus is on the rupee (now 52.1/USD), as India is seeing capital outflows while suffering from high inflation and twin deficits. The Korean won also was sharply lower, despite consumer confidence rising to a six-month high and despite the passage of a new Free Trade Agreement with the United States. In Indonesia, Deputy Governor Hartadi Sarwano said that the central bank will continue to smooth volatility in the rupiah, as the currency dropped 1.5% to 9,170 per dollar on Friday. The near-term outlook remains tenuous for Asian currencies on heightened global risk aversion.

Markets retreat as no solution in Europe appears imminent

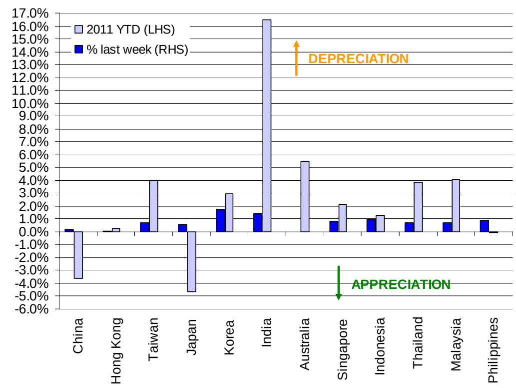
Equity markets also retreated this week. The Hang Seng index (-4.5%) and the Nikkei (-3.8%) were lower, as some of the more liquid markets sold off sharply. Sovereign CDS spreads were wider, essentially mirroring the regional selloff in currencies. Corporate high grade and high yield bonds sold off, and spreads were wider, particularly in the consumer sectors. However, the sovereigns are the focus, with Japan being warned by S&P about a future downgrade – the IMF noted that Japan faces a potentially destabilizing 'sudden surge' in yields similar to what has occurred in Europe if it fails to rein in its deficits. Our basecase scenario we still think Japan will grow by 2.7% y/y in 2012, as a rebound post-earthquake will continue despite high debt levels and a challenging macro environment.

Chart 3
Stock markets



Source: BBVA Research and Bloomberg

Chart 4
Foreign exchange markets



Source: BBVA Research and Bloomberg

Economic Analysis

Highlights

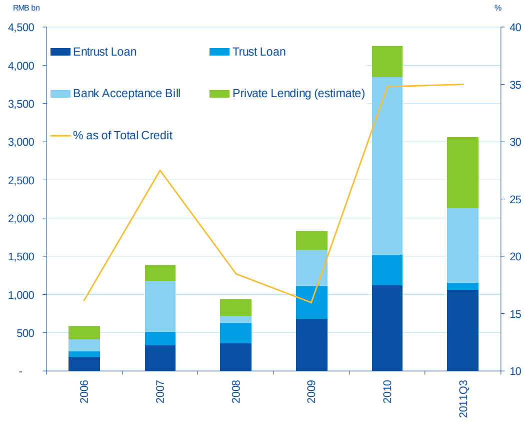
China's shadow bank lending: assessing the risks to financial stability

As markets focus on increasing risks of a hard landing in China, one topic that has attracted special attention in recent months is the growth of the shadow bank system and challenges it may pose to broader financial stability. Our newly released Banking Watch sheds light on this issue, *China's shadow bank lending: a threat to financial stabilty?*

China's informal and unregulated shadow banking system has grown rapidly in the past two years (Chart 5), and now accounts for over one-fifth of total credit in the economy. In the past, the shadow banking system has played a useful function in channeling credit to profitable businesses, especially SMEs that might otherwise have been credit constrained. However, the pace of such lending has picked up sharply in recent years, due both to efforts by depositors to shift from standard bank accounts to higher yielding wealth management products (Chart 6), as well as the incentives for lenders to circumvent tighter prudential regulations imposed on the formal banking system. This has given rise to a number of financial stability concerns. A first risk relates to lending concentration. Most of the recent lending associated with the boom in shadow banking has been extended to real estate developers, who face increasing challenges in selling housing units at the prices they had originally projected. A second risk stems from maturity mismatches, as the funding of shadow-bank vehicles are often very short term and increasingly expensive given the recent tightening monetary policy cycle. A third risk lies in potential liquidity shortages within deposit-taking institutions, particularly if shadow banking continues to attract savings deposits looking for higher yields. On the other hand, a sudden change in policy which favors deposit-taking institutions in the formal sector in attracting deposits could create sudden liquidity shortages in shadow banking vehicles, and thereby increase their dependence on short term funding even further.

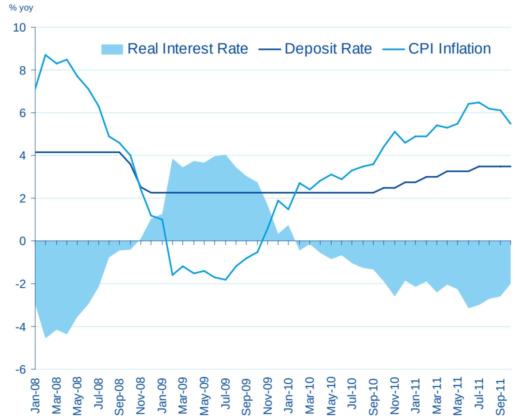
We believe the overall risks outlined above are manageable as long as the authorities take timely steps to slow the growth of credit extension in the informal part of the financial sector and also step up its oversight. While capital requirements have been introduced in some parts of the formal financial sector (namely trust companies) others parts remain untouched. Furthermore, capital requirements are still lower for trust companies than banks so more efforts are needed to avoid regulatory arbitrage. One crucial measure to discourage shadow banking is interest rate liberalization, especially on the deposit side, where rates are currently subject to a cap. Such liberalization would allow deposit-taking institutions to compete for wholesale deposits as well as those of affluent households. Finally, it would also be helpful to encourage banks to service SMEs better, not through directed lending, but rather through indirect policies such as subsidized lending rates.

Chart 5
China's shadow bank lending has accelerated



Source: BBVA Research and Bloomberg

Chart 6
China's real deposit rates are negative



Source: BBVA Research and Bloomberg

Trans Pacific Partnership (TPP) seeks to expand trade

At the annual meeting of the Asia-Pacific Economic Cooperation forum hosted in Honolulu last week, leaders from nine countries – Australia, Brunei, Chile, Malaysia, New Zealand, Peru, Singapore, Vietnam, and the United States – banded together to announce the broad outlines of a Trans-Pacific Partnership (TPP). The TPP would form a regional free-trade agreement to eliminate tariffs among its members by end-2015, and establish a framework for setting rules of origin, trade remedies, technical barriers to trade, investment, intellectual property, government procurement and competition policy, among others. Canada, Japan and Mexico have also expressed their interest in joining the TPP. Although regional trade deals are not necessarily welfare improving (in particular, if they lead to "trade diversion" rather than "trade creation"), at this stage the TPP should be taken as good news for the development of global trade, which could otherwise come under the threat of protectionism amidst the global slowdown. If the three potential members (Canada, Japan and Mexico) are included, the total GDP of TPP members would account for around 70% of APEC countries' total GDP, almost 40% of world GDP, and 25% of global trade.

Despite a high-profile start, the TPP is still far from getting off the ground. One large challenge is that the three largest emerging economies in APEC, namely China, Russia and Indonesia, have showed little interest. In particular, a high standard for protection of intellectual property rights and government procurement procedures would make it hard for China to comply in the near term. Some Chinese critics have even questioned whether the standards have been set in a way to exclude China. In any event, greater protection of intellectual property and reducing the role of government in the economy are, in various forms, part of the reforms under way, and appear well understood as being in China's long-term interest. The existence of the TPP could well prompt China to pick up the pace of these reforms.

Calendar Indicators

China	Date	Period	Prior	Cons.
Industrial Profits YTD (YoY)	27-Nov	OCT	27.0%	- -
PMI Manufacturing	1-Dec	NOV	50.4	49.9
HSBC Manufacturing PMI	1-Dec	NOV	51.0	- -
India	**Date**	**Period**	**Prior**	**Cons.**
Qtrly GDP (YoY)	30-Nov	3Q	7.7%	6.8%
Exports (YoY)	1-Dec	OCT	36.4%	- -
Imports (YoY)	1-Dec	OCT	17.2%	- -
Indonesia	**Date**	**Period**	**Prior**	**Cons.**
Inflation (YoY)	1-Dec	NOV	4.42%	- -
Core Inflation (YoY)	1-Dec	NOV	4.43%	- -
Exports (YoY)	1-Dec	OCT	46.3%	- -
Japan	**Date**	**Period**	**Prior**	**Cons.**
Overall Hhold Spending (YoY)	29-Nov	OCT	-1.9%	- -
Retail Trade (MoM) SA	29-Nov	OCT	-1.5%	- -
Industrial Production (MoM)	30-Nov	OCT P	-3.3%	- -
Vehicle Production (YoY)	30-Nov	OCT	-4.5%	- -
Construction Orders (YoY)	30-Nov	OCT	-9.3%	- -
Vehicle Sales (YoY)	1-Dec	NOV	28.3%	- -
Philippines	**Date**	**Period**	**Prior**	**Cons.**
Qtrly GDP (YoY)	28-Nov	3Q	3.4%	4.1%
Korea	**Date**	**Period**	**Prior**	**Cons.**
Industrial Production (MoM)	30-Nov	OCT	1.1%	0.2%
CPI Inflation (YoY)	1-Dec	NOV	3.9%	4.4%
Core Inflation (YoY)	1-Dec	NOV	3.7%	- -
Exports (YoY)	1-Dec	NOV	9.3%	10.0%
Imports (YoY)	1-Dec	NOV	16.4%	12.5%
Thailand	**Date**	**Period**	**Prior**	**Cons.**
Exports (YoY)	30-Nov	OCT	18.4%	- -
Imports (YoY)	30-Nov	OCT	42.6%	- -
CPI Inflation (YoY)	1-Dec	NOV	4.19%	4.50%
Core Inflation (YoY)	1-Dec	NOV	2.89%	2.90%
Vietnam	**Date**	**Period**	**Prior**	**Cons.**
Exports YTD (YoY)	24-30 NOV	NOV	34.6%	- -
Imports YTD (YoY)	24-30 NOV	NOV	27.2%	- -
Industrial Production (YoY)	24-30 NOV	NOV	5.3%	- -

Indicator of the Week: China PMI for November (December 1)

Forecast: 50.1	Consensus: 49.9	Prior: 50.4

Comment: GDP growth has so far been moderating in line with a soft landing. However, downside risks have increased due to external headwinds and the effects of recent policy tightening. The latest flash estimate of the private sector (Markit) PMI for November fell sharply, to 48.0 in November from 51.0 in October. However, as the official PMI covers a larger set of domestically-oriented companies which are still growing, we expect the index to remain just within the 50+ expansion zone for November. Market impact: A lower-than-expected reading would aggravate concerns of a hard-landing, raising expectations of further policy stimulus in China, and denting the already weak sentiment about global growth prospects.

	Current	Consensus
Thailand – BoT Monetary Policy Meeting, November 30	**Current**	**Consensus**
We expect a hike of 25 bps in the benchmark interest rate	3.50%	3.00%
Philippines – Central Bank of the Philippines Meeting, December 1	**Current**	**Consensus**
We expect the overnight borrowing rate to remain unchanged	4.50%	4.50%

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Markets Data

STOCK MARKETS

INDEX	Last price	% change over a week	Year to date	% Change over 1 Y
China – Shanghai Comp.	2397.9	-0.8	-14.6	-17.3
Hong Kong – Hang Seng	17791.8	-3.8	-22.8	-22.8
Taiwan – Weighted	6865.3	-5.1	-23.5	-17.8
Japan – Nikkei 225	8173.3	-2.4	-20.1	-18.9
Korea – Kospi	1781.5	-3.1	-13.1	-7.6
India – Sensex 30	15858.5	-3.1	-22.7	-17.9
Australia – SPX/ASX 200	3986.2	-4.6	-16.0	-13.2
Singapore – Strait Times	2667.3	-2.3	-16.4	-15.6
Indonesia – Jakarta Comp	3661.1	-2.5	-1.1	-1.1
Thailand – SET	980.5	-0.4	-5.1	-1.6
Malaysia – KLCI	1435.4	-1.3	-5.5	-4.1
Philippines – Manila Comp.	4231.3	-1.7	0.7	3.3

Last update: Friday, 11.45 Hong Kong time.

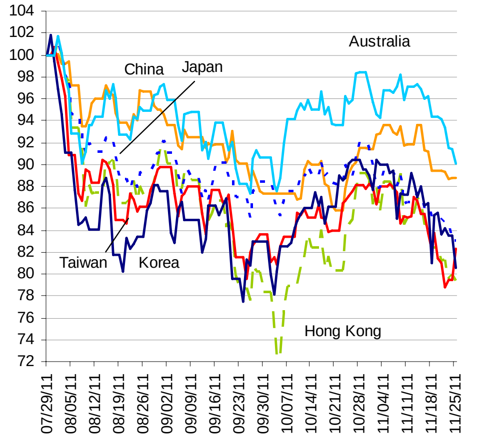
FOREIGN EXCHANGE MARKETS

CURRENCY	Spot	% change over a week	Forward 3-month	Forward 12-month
China (CNY/USD)	6.37	-0.21	6.39	6.39
Hong Kong (HKD/USD)	7.79	-0.07	7.79	7.78
Taiwan (TWD/USD)	30.5	-0.71	30.47	30.19
Japan (JPY/USD)	77.4	-0.59	77.18	76.43
Korea (KRW/USD)	1159	-1.71	1165	1169
India (INR/USD)	52.1	-2.24	52.12	54.02
Australia (USD/AUD)	0.97	-3.06	1.04	n.a.
Singapore (SGD/USD)	1.31	-0.81	1.31	1.30
Indonesia (IDR/USD)	9109	-0.98	9450	9900
Thailand (THB/USD)	31.2	-0.67	31.45	31.88
Malaysia (MYR/USD)	3.19	-0.71	3.21	3.23
Philippines (PHP/USD)	43.8	-0.86	43.94	43.96

Last update: Friday, 11.45 Hong Kong time.

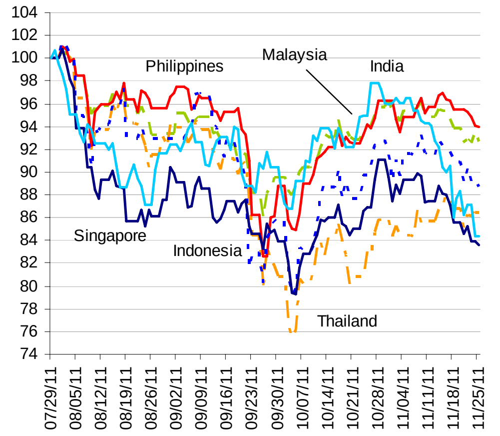
Charts

Chart 9
Stock Markets



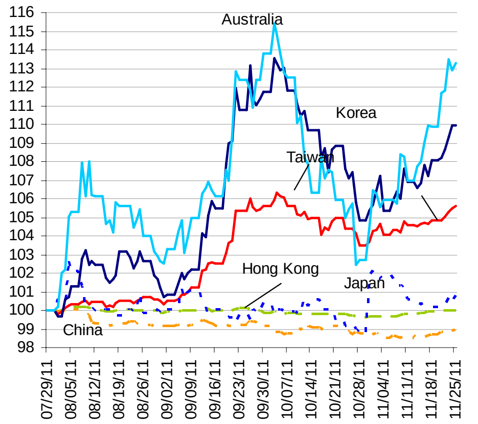
Source: BBVA Research and Bloomberg

Chart 10
Stock Markets



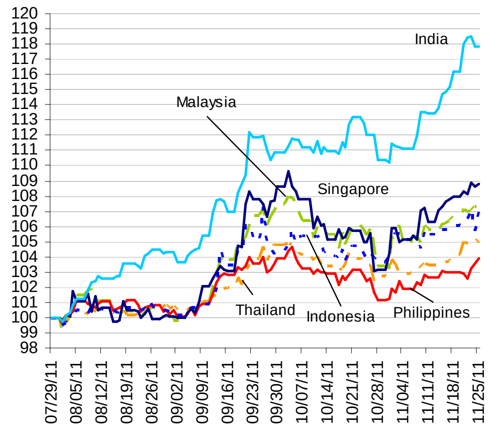
Source: BBVA Research and Bloomberg

Chart 11
Foreign Exchange Markets



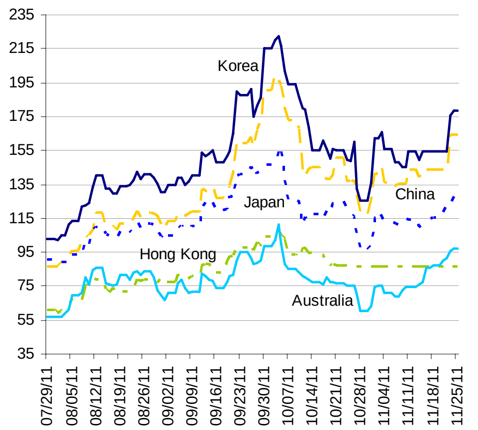
Source: BBVA Research and Bloomberg

Chart 12
Foreign Exchange Markets



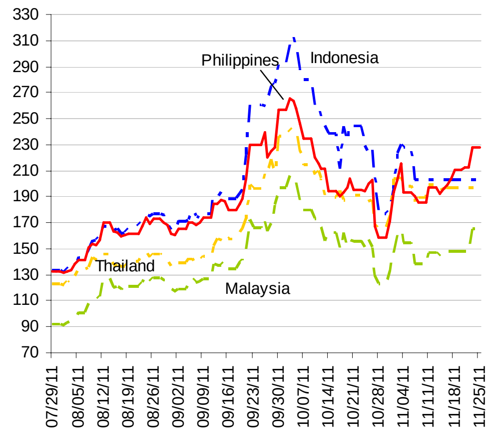
Source: BBVA Research and Bloomberg

Chart 13
Credit Default Swaps



Source: BBVA Research and Bloomberg

Chart 14
Credit Default Swaps



Source: BBVA Research and Bloomberg

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