

Asia

Weekly Watch

Hong Kong, November 12, 2010

Economic Analysis

Asia

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China inflation triggers more tightening

The key takeaway from this week's release of monthly data in China is that inflation is rising at a faster-than-expected pace (4.4% y/y in October). The authorities responded with another hike in reserve requirements, and markets are anticipating more tightening in the coming weeks or months. Separately, China received a rating's upgrade by Moody's to Aa3. Meanwhile, the successful conclusion of the G20 Summit in Seoul should help alleviate rising tensions over currency issues, at least for a while.

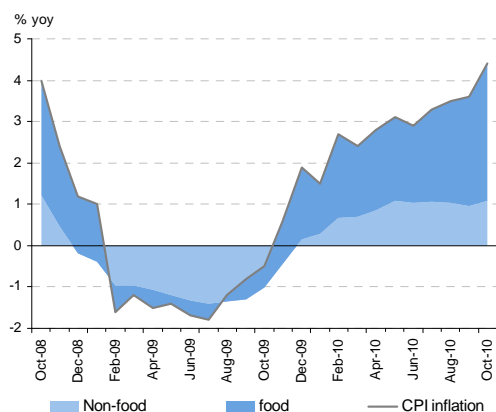
Asia titled towards a renewed strong growth, amidst inflation concerns

In addition to the sharp rise in China's inflation, activity indicators showed that growth momentum remains strong, largely in line with expectations (see Highlights). Elsewhere, Hong Kong's third quarter GDP (6.8% y/y) came in above expectations (consensus: 6.1%; BBVA 6.5%), as the authorities continue to worry about risks of asset (property) price bubbles. Machine orders in Japan declined more than expected, and exports in Taiwan (21.9% y/y) and the Philippines (46.1% y/y) came in well above expectations. On the monetary front, Malaysia left rates unchanged at 2.75% as expected.

In the coming week...

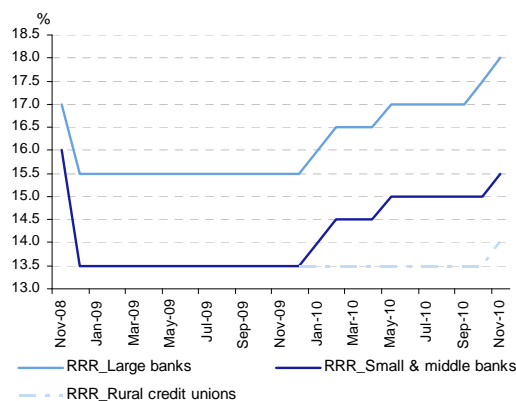
Next week will feature third quarter GDP in Japan and Taiwan, FDI in China (October), October WPI inflation in India, and October exports for Singapore. On the monetary policy front, we expect a 25bp hike in Korea, and for the Philippines to stay on hold.

Chart1
Rising inflationary pressures in China...



Source: BBVA Research and Bloomberg

Chart2
...have triggered another hike in the RRR



Source: BBVA Research and Bloomberg

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Highlights

China's growth momentum and rising inflation prompt tightening

Markets expects more measures to cool Chinese economy

The G20's significance for Asia

The G20 endorse further macro-prudential measures in the region

Will Hong Kong maintain its peg to the US dollar?

The possibility of change is slim in the short run

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Concerns about “capital controls” rising

G20 leaders met in Seoul this week, but they have so far been unable to narrow differences on either exchange rate policy coordination or the commitment to avoid excessive short-term capital flows in the post-QE2 world. With continued threat of hot money flows, we believe there is a rising risk in the region of new capital account measures in addition to further sterilized fx intervention to pre-empt asset bubble formation. In fact, the risks have already come to the surface. For example, Korea’s senior officials have indicated that they may revive a 14% tax on treasury and central bank bonds held by foreigners next year. Meanwhile, the US dollar rebounded on the back of renewed fears of European sovereign debt problems as Germany indicated that the cost of any Greek-style bail-out to be partly born by private investors. Asian currencies generally fell, but the magnitude is still small compared to the gains in the past few weeks.

CNY is the major outlier, rising 0.46% to 6.6298 against the dollar. This is the strongest level since its announcement of greater flexibility policy in June. The rise in the yuan this week was widely perceived as a political move to defuse tensions during the G20 meeting this week. But given the hefty trade surplus and inflation rising above 4.0%, we believe it is in China’s interest to continue the gradual appreciation of CNY to achieve its macro objective. Hence we continue to see CNY to appreciate to 6.3 by end-2011 (slightly stronger than 6.4460 in 12-month NDF). That said, gradualism and two-way movements are still the most likely path towards our target.

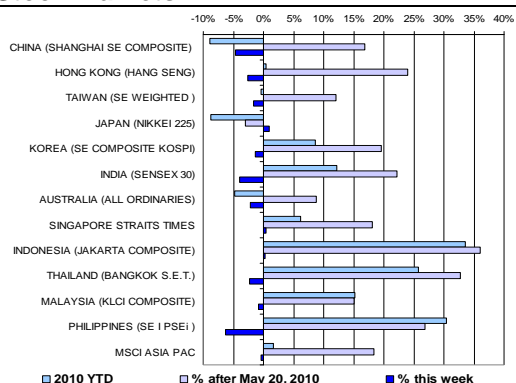
The KRW fell on the fear of new “capital control” measures after the G20 meeting. Ruling party lawmaker, Bank of Korea and senior government officials all have indicated their intention, and possible measures include further restrictions on banks’ fx positions, limits on short-term borrowing and withholding taxes.

AUD fell below parity against the dollar in response to rising risk aversion and higher-than-expected jobless rate. Although job creation was still strong, more workers came back to the labor market pushed up the headline figure. We believe RBA’s tightening bias remains, but it will likely take a pause next month after the hike last week. Household survey also showed inflation expectation fell, obviating the immediate needs for further rate hikes. In the absence of positive catalysts and in light of the USD rebound, AUD will likely struggle to consolidate at the parity level in the near term.

Stock markets were mostly down this week despite a strong start at the beginning of the week on strong corporate gains, and by an improvement in the US job market. However, China’s data showing that the economy is still growing too fast and that inflation is rising, triggered tightening measures, and expectations of more such measures ahead. Moreover, some markets are still affected by profit taking, as many stock markets are still in almost historical levels. Renewed concerns about Europe’s sovereign debt problems also dragged down Asian markets. The Philippines market dropped by 6.3% this week, with cumulative losses of 7.3% since November 4th. On the other hand, the Nikkei climbed by 1% due in part to a weaker yen. Meanwhile, Korean authorities are investigating the cause of a sudden plunge by 2.5% on the very last moment of trading on Tuesday.

Chart 3

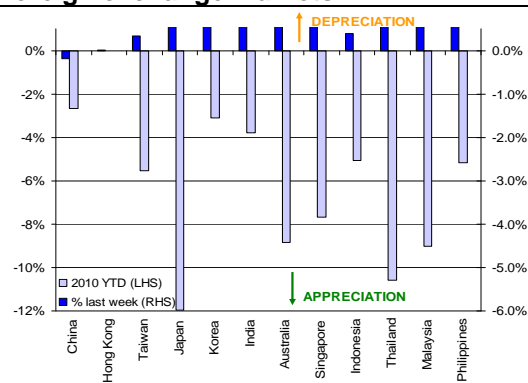
Stock markets



Source: BBVA Research and Bloomberg

Chart 4

Foreign exchange markets



Source: BBVA Research and Bloomberg

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Economics Analysis

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Highlights

China's growth momentum and rising inflation prompt tightening

China's latest batch of monthly indicators, released this past week, shows that inflation is rising and that activity remains brisk. Inflation for the month of October accelerated faster than expected, to 4.4% y/y (consensus: 4.0%) on account of a further rise in food prices, and well about the authorities' 3% comfort range. Meanwhile, retail sales (18.6% y/y) and urban fixed asset investment (23.7% y/y) remained strong. New loans amounted to RMB 587.7 billion in October, sharply higher than consensus (RMB 450.0 billion), while property price increases slowed to 8.6% y/y (consensus 8.9%) due to ongoing efforts to cool the property market. The trade surplus for October widened, as imports came in slightly lower than expected.

In response to the strong data, especially rising inflation, the People's Bank of China (PBoC) has implemented further tightening measures, including another 50bp hike in the required reserve ratio (RRR) announced this past week. The authorities are taking an increasingly aggressive approach to monetary tightening, which is appropriate in our view, as described in our recent [China Economic Outlook](#). Although inflation may turn out somewhat higher than we previously projected (of 3.2% y/y by end-year), we continue to expect the authorities to achieve an economic soft landing, with *at least* two more rate hikes in 2011 and further hikes in the RRR.

The G20's significance for Asia

The significance of the G20 Summit for Asia goes beyond talk of currency wars, capital flows, and reform of the international monetary system, although these are of course all important topics. The meeting, held in Korea, is the first time a G20 Summit has been held in a non-G8 venue. It marks, in a sense, a coming of age for the region. Increasingly, Asia's economic issues—led by the growing emergence of China, which is now the world's second largest economy—are becoming crucial for trade and finance in the rest of the world. Not surprisingly, agreement has been reached to reform the voting shares within the IMF to reflect Asia's growing importance in the world economy. The meeting is also a showcase for the Korean economy, which has rebounded sharply from the downturn of 2008-09, underscoring the resilience of its economy (see our [Asia Economic Watch](#) on Korea).

The outcome of the G20 should help to ease currency tensions in the region, at least for a while. While lacking in details, the "Seoul Action Plan" emphasizes the shared responsibility between advanced and emerging economies and among groups of emerging market economies to resolve global imbalances and avoid protectionism. It calls for the use of "indicative guidelines" to measure imbalances, and for a move towards market-determined exchange rates. It also endorses the use of "carefully designed macro-prudential measures" (read: capital controls) in countries with overvalued exchange rates.

Will Hong Kong maintain its peg to the US dollar?

The combination of rising RMB deposits in Hong Kong (see the last [Weekly](#)) and strong capital inflows being fueled by the US Fed's low interest rates and quantitative easing (QE2) have raised questions about how long Hong Kong will maintain its currency peg to the US Dollar. The first issue, the rise in RMB deposits, fostered in part by China's RMB trade settlement program, has raised questions about whether the RMB will eventually replace the Hong Kong dollar as legal tender. The second issue, about capital inflows, underscores the monetary policy dilemma facing Hong Kong given that its economy (which is booming) is out of cycle with the US—under the linked exchange rate system, Hong Kong must keep interest rates at US level, and therefore effectively "imports" its (lax) monetary policy from the US.

We believe that any changes to Hong Kong's currency arrangement are highly unlikely in the near term. The authorities have recently reiterated their commitment to the arrangement, which has been in place since 1983 and which is enshrined in Hong Kong's Basic Law. The rise in RMB deposits in Hong Kong is likely to continue, but need not undermine the Hong Kong dollar's status as legal tender. In addition, a shift to an RMB peg is premature given that the prerequisites for use of China's currency as a peg are not yet in place. In particular, the RMB is not fully convertible. Moreover, the degree of

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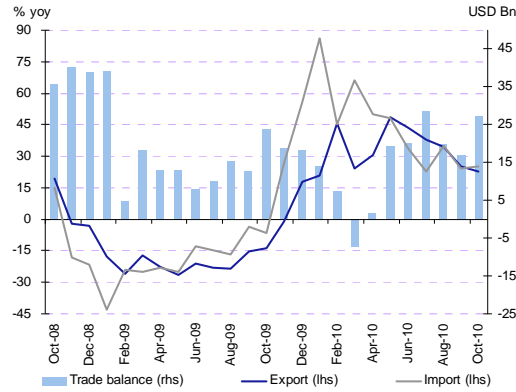
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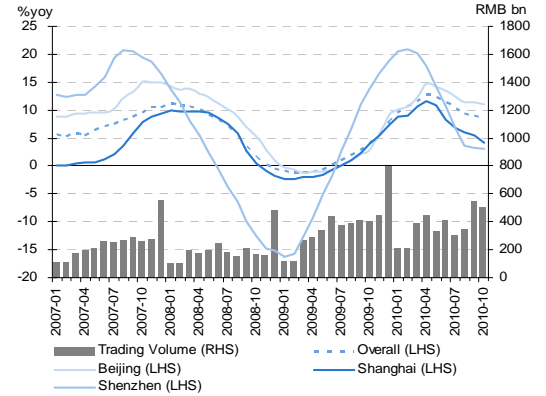
synchronization in economic cycles between the Mainland and Hong Kong is not yet sufficiently high to make the RMB a natural choice as a peg. For these reasons, although the difference in economic cycles between Hong Kong and the US pose challenges under the current currency arrangement, there are at present no better alternatives. We believe, therefore, that any changes are still several years away.

Chart 5
China's trade balance widened further in October



Source: BBVA Research and Bloomberg

Chart 6
China's housing prices are moderating on recent tightening measures



Source: BBVA Research and Bloomberg

What to watch

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Japan: 3Q GDP growth (November 115)

Forecast: 2.6% q/q annualized **Consensus:** 2.5% **Previous:** 1.5%

Exports, the main driver of Japan's economic recovery, are weakening, and business investment and private consumption are expected to sustain growth instead. Business investment is expected to grow steadily, thanks to a recovery of corporate profits. Japan's recovery has slowed since the second quarter (1.5% q/q, annualized) as exports are losing momentum and domestic demand remains weak. We forecast GDP growth of 3.0% and 1.6% respectively in 2010 and 2011. Meanwhile, the economy also continues to struggle with deflation. Weaker-than-expected growth will further dampen expectations for the outlook, already dragged down by the strong Yen.

Calendar

China	Date	Period	Prior	Cons.
Actual FDI (YoY)	12-16 Nov	OCT	6.10%	10.40%
Hong Kong	Date	Period	Prior	Cons.
Unemployment Rate SA	16-Nov	OCT	4.20%	--
India	Date	Period	Prior	Cons.
Monthly Wholesale Prices YoY%	15-Nov	OCT	8.62%	8.50%
Japan	Date	Period	Prior	Cons.
GDP Annualized	15-Nov	3Q P	1.50%	2.50%
GDP Deflator YoY	15-Nov	3Q P	-1.70%	-1.50%
Industrial Production (MoM)	15-Nov	SEP F	-1.90%	--
Tertiary Industry Index (MoM)	16-Nov	SEP	-0.20%	-0.60%
Machine Tool Orders (YoY)	16-Nov	OCT F	70.90%	--
All Industry Activity Index (MoM)	19-Nov	SEP	-0.40%	-0.60%
Korea	Date	Period	Prior	Cons.
Department store sales yoy	18-Nov	OCT	6.40%	--
Discount store sales yoy	1418Nov	OCT	18.00%	--
Philippines	Date	Period	Prior	Cons.
Overseas Remittances (YoY)	15-Nov	SEP	9.80%	--
Balance of Payments	17-Nov	OCT	\$3062M	--
Singapore	Date	Period	Prior	Cons.
Retail Sales Ex Auto	15-Nov	SEP	6.20%	6.90%
Retail Sales (MoM) sa	15-Nov	SEP	2.20%	-3.00%
Electronic Exports (YoY)	16-Nov	OCT	21.20%	27.10%
Non-oil Domestic Exp SA (MoM)	16-Nov	OCT	-4.50%	-5.70%
GDP (QoQ)	18-Nov	3Q F	-19.80%	--
Taiwan	Date	Period	Prior	Cons.
GDP - Constant Prices (YoY)	18-Nov	3Q	12.53%	8.00%
Export Orders (YoY)	19-Nov	OCT	16.68%	15.00%
Current Account Balance (USD)	19-Nov	3Q	10559M	--

Korea – 7-day Repo Rate, November 18

We expect interest rates will rise by 25bps

Current	Expected
2.25	2.50

Philippines – Overnight Borrowing Rate, November 18

We expect interest rates will remain unchanged

Current	Expected
4.00	4.00

Hong Kong – Composite interest Rate, November 18

We expect interest rates will remain unchanged

Current	Expected
0.18	0.18

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Asia Market

STOCK MARKETS	INDEX	Last price	% change over a week	Year to date	% Change over 1 Y
	China – Shanghai Comp.	2985.4	-4.6	-8.9	-5.9
	Hong Kong – Hang Seng	24222.6	-2.6	10.7	8.1
	Taiwan – Weighted	8316.1	-1.6	1.6	8.4
	Japan – Nikkei 225	9724.8	1.0	-7.8	-0.8
	Korea – Kospi	1913.1	-1.3	13.7	21.6
	India – Sensex 30	20194.8	-3.9	15.6	21.0
	Australia – SPX/ASX 200	4692.7	-2.2	-3.7	-1.2
	Singapore – Strait Times	3253.4	0.4	12.3	19.3
	Indonesia – Jakarta Comp	3665.8	0.3	44.6	51.5
	Thailand – SET	1015.6	-2.4	38.3	45.8
	Malaysia – KLCI	1499.8	-0.8	17.8	17.9
Philippines – Manila Comp.	4076.7	-6.3	33.5	32.6	

Last update: Friday, 16.45 Hong Kong time.

FOREIGN EXCHANGE MARKETS	CURRENCY	Spot	% change over a week	Forward 3-month	Forward 12-month
	China (CNY/USD)	6.64	0.20	-0.03	-0.18
	Hong Kong (HKD/USD)	7.75	-0.02	-52.5	-271
	Taiwan (TWD/USD)	30.2	-0.34	-0.16	-0.68
	Japan (JPY/USD)	81.9	-0.78	-7.5	-49.4
	Korea (KRW/USD)	1128	-1.82	3.76	8.11
	India (INR/USD)	44.8	-1.21	72.3	218
	Australia (USD/AUD)	0.98	-3.05	118	n.a.
	Singapore (SGD/USD)	1.30	-0.88	-1.15	-1.5
	Indonesia (IDR/USD)	8928	-0.39	43	288
	Thailand (THB/USD)	29.8	-0.60	5.00	17.5
	Malaysia (MYR/USD)	3.12	-1.05	82.5	327
Philippines (PHP/USD)	43.8	-2.40	-0.03	0.16	

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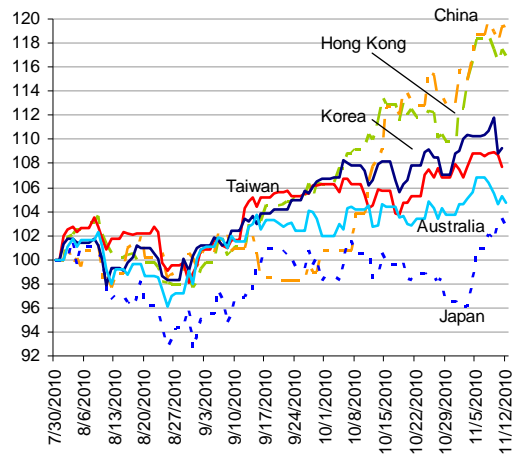
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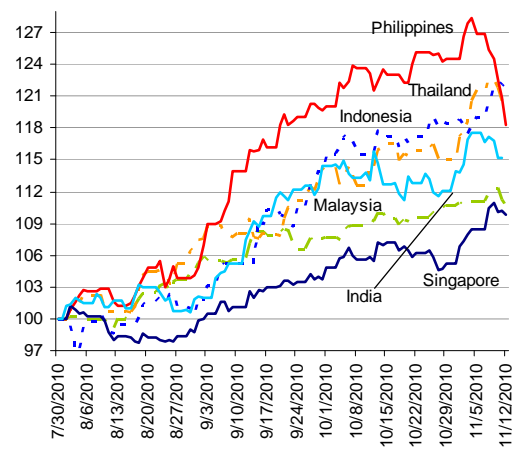
Asia Chart

STOCK MARKETS



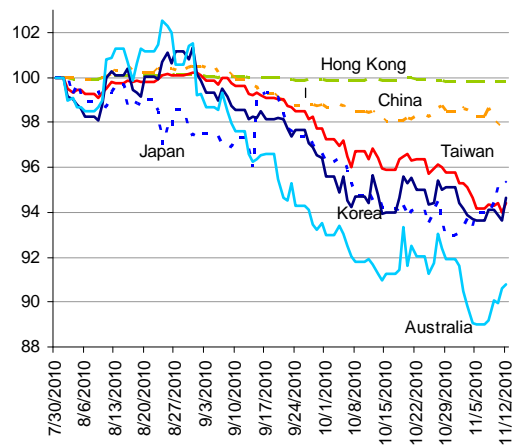
Source: BBVA Research and Bloomberg Index=100

STOCK MARKETS



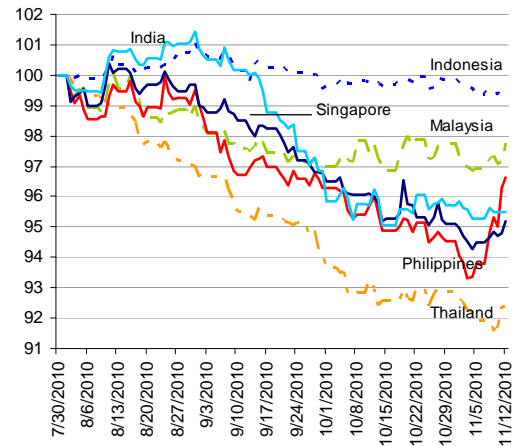
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FOREIGN EXCHANGE MARKETS



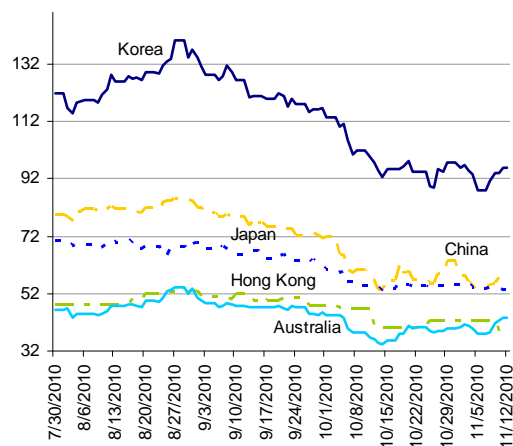
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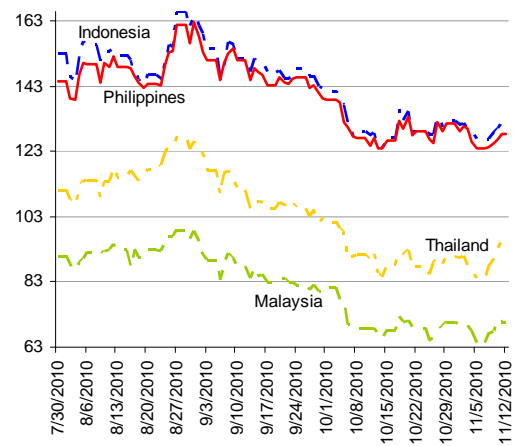
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