BBVA Research

Asia

Weekly Watch

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Economic Analysis

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Rising oil prices fail to dent sentiment

Asian equity and FX markets recovered some of their recent losses this past week, as fears of abrupt tightening in China eased, and as calm prevailed despite tensions in the Middle East and elevated oil prices. A further moderating trend in China's latest PMI reading provided evidence that the authorities' tightening measures are working to achieve a soft landing (although sentiment could be swayed by an important batch of February indicators to be released next week). Meanwhile, markets appear to think that the oil price spikes will not be long-lasting. In particular, strong regional growth momentum, healthy fiscal balances, and current account surpluses should help contain risks from rising oil prices, although inflation will remain an challenge (see Highlights).

Inflation eases, but pressures persist

Korea, Indonesia, Thailand and the Philippines released their February inflation figures with contrasting results. Inflation in Indonesia (6.84% y/y) and Thailand (2.87% y/y) both slowed from the previous month and were below expectations (consensus: 7.13% and 3.0%, respectively), while Korea (4.5% y/y) and the Philippines (4.3% y/y) saw another acceleration in their inflation rates (consensus: 4.3% and 3.7%, respectively). In Korea this is the second straight month exceeding the official target range of 2-4%. On the growth front, India's 4Q GDP expanded by 8.2% y/y, slowing down from the third quarter's 8.9% y/y and lower than expectations (consensus: 8.6%). That said, the focus this past week in India was on the budget, which aims at further fiscal consolidation (see Highlights).

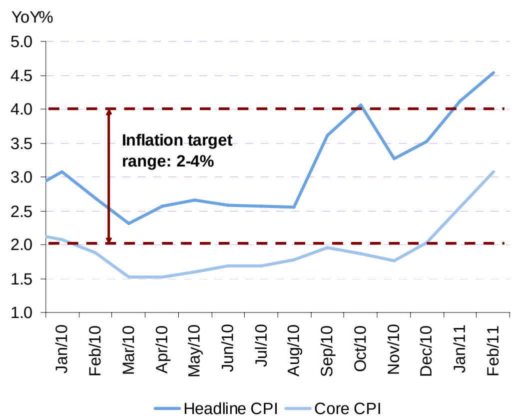
In the coming week…

China will be the focus of attention, with February inflation (see What to Watch), along with trade data, FDI, new yuan loans and money supply. In Japan, GDP, current account and trade data will be of interest. February inflation will be released in Taiwan. Monetary policy meetings will take place in Korea, Thailand and Malaysia; we expect another 25bp interest rate hikes in Korea and Thailand, and for Malaysia to stay on hold (see Calendar).

Chart1
China's February PMI eases for a third straight month

Source: BBVA Research and Bloomberg

Chart2
Korea's inflation continues to rise



Source: BBVA Research and Bloomberg

Highlights

China policy conferences to yield details on the development strategy
Emphasis on a rebalancing of growth towards domestic demand

India's budget focuses on fiscal consolidation
A further welcome cut in the deficit, though criticism centers on optimistic assumptions

How well can Asia withstand an oil price shock?
Barring an unexpected spike, Asia appears well positioned to absorb an increase in prices

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Oil Spikes Still Hold Market Attention

Oil prices remained at elevated levels this past week as markets worried that Libya's oil supply facilities would be damaged by internal fighting. Despite concerns, our commodity analyst points out that OECD inventories and OPEC spare capacity could provide adequate cushion from any shortfalls in Libya's supplies, with global oil supplies unlikely being disrupted. Nevertheless, as long as other oil producing countries are still susceptible to contagion and social unrest, oil prices may not fall quickly, which would have ramifications on growth and inflation beyond our base-case.

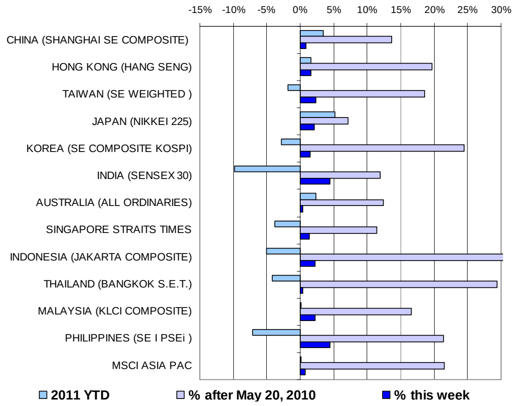
The scale and the durability of the oil price spike matter. Our economists estimate that Asian economies are robust to a scenario where Brent oil average $100-$120 per barrel (see Highlights). In this scenario, current account surplus in the region would be modestly lower, and direct impacts on CPI inflation broadly manageable. At the margin, the dents on the current account in Korea, Taiwan and Thailand would be relatively larger given their dependence on oil imports, and their currencies would face less appreciation pressure. On the contrary, the MYR, IDR and SGD may outperform as they are oil producers/ refiners and the monetary authorities of the latter two are willing to endorse stronger currency to fight inflation.

In a worse scenario where oil prices stayed above $120/b persistently, the world would be more susceptible to a sharp economic slowdown, and the negative implications would be amplified. Flight to safety would dominate in global financial markets, exerting downward pressure on risk-sensitive Asian FX. The markets would also start questioning the external financing capability of current account deficit countries such as India and Vietnam.

Thus far, Asian FX and equities markets have been relatively resilient despite that the Brent crude futures hovered above $110/b for two weeks. The resilience was partly due to strong macro indicators – China's PMI and Korea's exports, which continued to support healthy regional growth. Inflation risks, rather than lower growth, are probably more imminent market concerns, as energy price increases could pass through to broader inflation in a growth environment with limited spare capacity. But note that Asian authorities, except for India, Malaysia and the Philippines, have large fiscal space to augment subsidies to slow energy price increases in the first place. Hong Kong and Singapore's recent budgets are examples. The negative impacts of higher oil prices on domestic inflation may be delayed, obviating the needs for more aggressive tightening ahead.

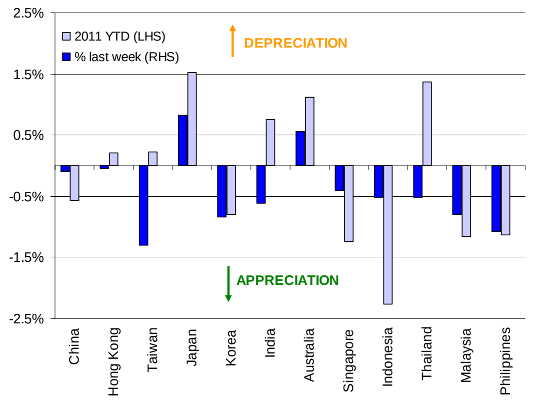
Upbeat US data and reduced concerns on oil prices led Asian stocks to gain in the past week. The MSCI Asia index rose 0.75% in the week, in which stock indices in most of the countries climbed, as in China (0.90%), Japan (2.13%), Taiwan (2.36%), Hong Kong (1.65%), India (4.46%), Singapore (1.41%), Malaysia (2.15%), the Philippines (4.39%), Thailand (0.42%) and Indonesia (2.17%). As the only exception, Vietnam (-1.61%) extended losses.

Chart 3
Stock markets



Source: BBVA Research and Bloomberg

Chart 4
Foreign exchange markets



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Highlights

Policy conferences to yield details of China's updated development strategy

Two important government annual conferences - the National People's Congress (NPC) and the Chinese People's Political Consultative Conference (CPPCC) - are getting underway this week, and will remain in session through mid-March. The so-called "dual conferences" are to endorse a series of policy documents submitted by the State Council (Cabinet), including the annual budget plan and the 12th five-year development plan (2011-2015). We expect the budget to maintain a supportive growth stance for the coming year, as monetary policy is further tightened to combat inflation. Regarding the new development plan, the emphasis is expected to include a rebalancing of growth towards domestic demand, especially private consumption; addressing income inequality and regional development disparities; and fostering of strategic emerging industries, including green technology. In particular, the official GDP target for 2011-2015, as has already been announced, will be reduced to 7.0%, from 7.5% over the previous five years. Nevertheless, the reduced target is still in line with our projected growth rates of at least 8%-9% in the coming years, as the target is actually viewed as a minimum growth floor (growth over the past five years was substantially above the target). Another key feature will be a sub-plan to establish 36 million units of public housing over the next five years, to help maintain housing affordability.

India's budget focuses on fiscal consolidation

India's 2011/12 budget was unveiled this past week, aiming at a further welcome reduction in the fiscal deficit, to a targeted 4.6% of GDP from an outturn of 5.1% in 2010/11 (revised budget estimates). The target is in line with the medium-term fiscal consolidation plans of the central government, intended to bring down the public debt ratio to 68% of GDP in 2014/15 from 79% in 2009/10. The budget also aims at boosting must-needed public infrastructure, the extension of FII limits on participation in infrastructure bonds from 5 to 25 billion USD, issuance of tax free infrastructure bonds for railways and road, and measures to foster agriculture infrastructure. Another highlight of the budget is that it will increase social spending by 20%, and also address social issues like food security and food inflation. Nevertheless, the budget forecasts have been criticized by market observers for relying on an optimistic GDP growth scenario of 9% in the coming fiscal year. The ongoing surge in oil prices also increase risks of higher subsidy outlays. The budget targets an increase in tax revenue of 17.9%, higher than the projected 14% nominal GDP growth; on the spending side, total expenditure is to be reduced to 14% of GDP from 15.4% and 16.4% in previous two years. Finally, the budget announcement left some observers disappointed as it lacked announcements of bold structural reforms in labor laws, governance issues, energy sector, and especially financial sectors, which are necessary to further liberalize the economy and ensure sustained rapid growth in the long term.

How well can Asia withstand an oil price shock?

As recent turmoil in the Middle East continues, market participants have begun to assess the impact of a possible sustained increase in oil prices on Asian economies. Our preliminary estimates suggest that the region is well-positioned to withstand an increase in Brent oil price in the range of USD 100/bbl to USD 120/bbl (Chart 5). Hefty current account surpluses (with the exception of India) provide buffers to the balance of payments, while strong public finances (again, except in India and perhaps the Philippines) would provide space for fiscal measures (subsidies) to slow the pass-through to domestic price increases. The external positions of net energy exporters, in particular Indonesia and Malaysia, would benefit from the price increase, while large oil net importers, such as Korea, India, Thailand and Taiwan would be more vulnerable, although high foreign exchange reserves provide a cushion. Turning to inflation, in the absence of offsetting fiscal measures, our estimates suggest that an increase in oil prices to the range discussed above would raise Asian CPI inflation by 2.3 percentage points on average. A sustained increase in oil prices would likely result in lower growth rates across the region, exacerbated by a decline in external demand. Given Asia's strong growth momentum, and indeed overheating pressures, we believe the region would be able to sustain such a shock with only a moderate impact on growth, on the order of 1-1.5 percentage points on average. Given the ongoing uncertainties about developments in the Middle East and the impact on energy markets, we will need to evaluate the impact as developments unfold.

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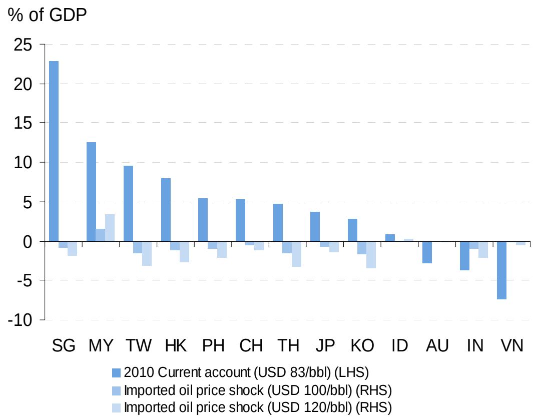
Chart 5

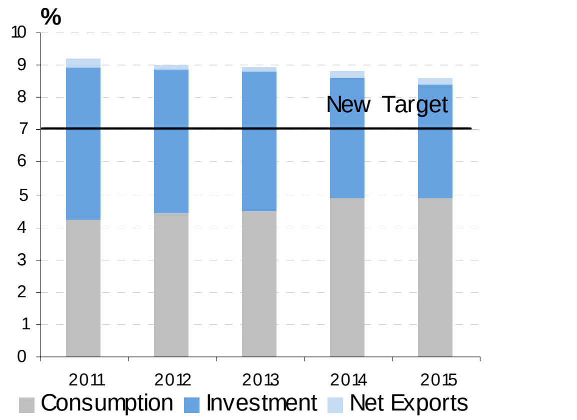
Current account surpluses in most of the region should help cusion an oil price shock



Source: BBVA Research and Bloomberg

Chart 6

China's GDP growth should exceed the new 7% growth target by a wide margin



Source: BBVA Research and Bloomberg

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What to watch

China: CPI for February (March 15)

Forecast: 4.6% y/y **Consensus 4.8% y/y** **Previous: 4.9% y/y**

Comment: February inflation will be released next week with a batch of other important indicators including the producer price index (PPI), new loans, M2 growth, trade, industrial production, retail sales, and investment. Headline inflation is expected to ease slightly as the recent monetary tightening measures take effect. However, the recent run-up of oil prices and tight labor market conditions will keep inflationary pressures high. Market impact: A higher-than-expected reading could unnerve markets through expectations of further tightening and risks of a hard landing.

Calendar

China	Date	Period	Prior	Cons.
Trade Balance (USD)	10-Mar	FEB	$6.45B	$4.80B
Exports YoY%	10-Mar	FEB	37.7%	23.0%
Imports YoY%	10-Mar	FEB	51.0%	32.0%
Industrial Production (YoY)	11-Mar	FEB	- -	13.0%
Consumer Price Index (YoY)	11-Mar	FEB	4.90%	4.80%
Retail Sales (YoY)	11-Mar	FEB	- -	18.70%
New Yuan Loans	11-15 MAR	FEB	1040.0B	700.0B
Money Supply - M2 (YoY)	11-15 MAR	FEB	17.20%	17.0%
Hong Kong	**Date**	**Period**	**Prior**	**Cons.**
Industrial Production (YoY)	11-Mar	4Q	5.40%	- -
Producer Price (YoY)	11-Mar	4Q	6.50%	- -
India	**Date**	**Period**	**Prior**	**Cons.**
Industrial Production YoY	11-Mar	JAN	1.60%	- -
Japan	**Date**	**Period**	**Prior**	**Cons.**
Japan Money Stock M2 YoY	8-Mar	FEB	2.30%	- -
Bank Lending Banks Adjust YoY	8-Mar	FEB	-1.60%	- -
Current Account Balance YOY%	8-Mar	JAN	30.50%	- -
Trade Balance - BOP Basis	8-Mar	JAN	¥768.8B	- -
Machine Orders YOY%	9-Mar	JAN	-1.6%	- -
GDP Annualized	10-Mar	4Q F	-1.1%	- -
Gross Domestic Product (QoQ)	10-Mar	4Q F	-3.0%	- -
Domestic CGPI (MoM)	10-Mar	FEB	0.5%	- -
Machine Tool Orders (YoY)	10-Mar	FEB P	89.8%	- -
Malaysia	**Date**	**Period**	**Prior**	**Cons.**
Industrial Production YoY	10-Mar	JAN	4.2%	- -
Philippines	**Date**	**Period**	**Prior**	**Cons.**
Total Exports (YoY)	10-Mar	JAN	25.3%	- -
Bank Lending (YoY)	11-Mar	JAN	8.9%	- -
Korea	**Date**	**Period**	**Prior**	**Cons.**
South Korea Money Supply M2	9-Mar	JAN	7.2%	- -
Producer Price Index (YoY)	10-Mar	FEB	6.2%	- -
Taiwan	**Date**	**Period**	**Prior**	**Cons.**
CPI YoY%	7-Mar	FEB	1.1%	1.1%
Total Trade Bal in US$ Billion	7-Mar	FEB	$1.88B	$1.20B
Total Exports (YoY)	7-Mar	FEB	16.6%	16.5%
Total Imports (YoY)	7-Mar	FEB	21.9%	19.2%

	Current	Expected
Thailand – Benchmark Interest Rate, March 9 We expect a 25bp interest rate hike	2.25	2.50
Korea – BOK Monetary Policy Committee Meeting, March 10 We expect a 25bp interest rate hike	2.75	3.00
Malaysia – Overnight Rate, March 11 We expect interest rates will be unchanged	2.75	2.75

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STOCK MARKETS

INDEX	Last price	% change over a week	Year to date	% Change over 1 Y
China – Shanghai Comp.	2904.8	0.9	3.4	-3.9
Hong Kong – Hang Seng	23392.6	1.7	1.6	13.7
Taiwan – Weighted	8802.8	2.4	-1.9	16.3
Japan – Nikkei 225	10751.4	2.1	5.1	6.0
Korea – Kospi	1991.8	1.4	-2.9	23.1
India – Sensex 30	18489.8	4.5	-9.8	8.9
Australia – SPX/ASX 200	4854.7	0.4	2.3	2.2
Singapore – Strait Times	3067.6	1.4	-3.8	10.8
Indonesia – Jakarta Comp	3520.9	2.2	-4.9	37.2
Thailand – SET	990.1	0.4	-4.1	35.5
Malaysia – KLCI	1521.3	2.1	0.2	18.5
Philippines – Manila Comp.	3901.2	4.4	-7.1	28.6

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)	6.57	0.10	6.52	6.41
Hong Kong (HKD/USD)	7.79	0.05	7.8	8
Taiwan (TWD/USD)	29.4	1.31	29.11	28.52
Japan (JPY/USD)	82.4	-0.81	82.3	81.9
Korea (KRW/USD)	1117	0.85	1123.46	1138.73
India (INR/USD)	45.0	0.95	45.7	48
Australia (USD/AUD)	1.01	-0.56	1	n.a.
Singapore (SGD/USD)	1.27	0.40	1.27	1.3
Indonesia (IDR/USD)	8792	0.52	8865	9252
Thailand (THB/USD)	30.5	0.53	30.53	30.8
Malaysia (MYR/USD)	3.03	0.78	3.0	3
Philippines (PHP/USD)	43.3	1.09	43.36	43.76

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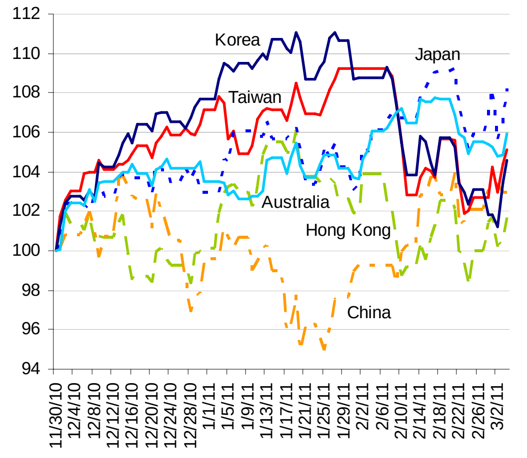

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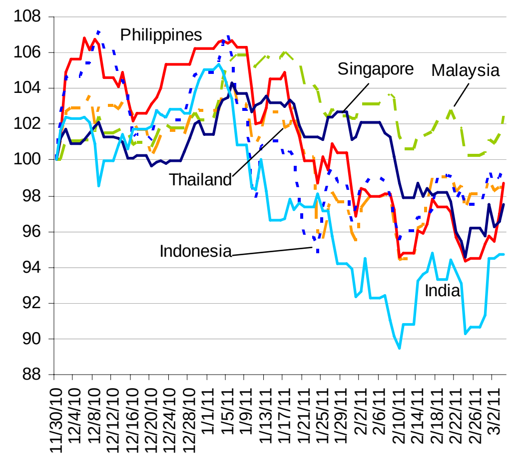
STOCK MARKETS



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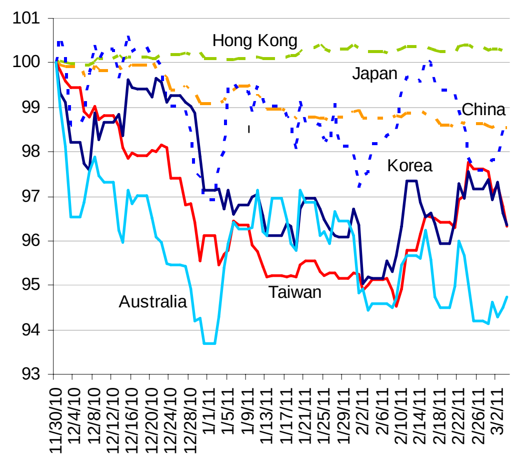

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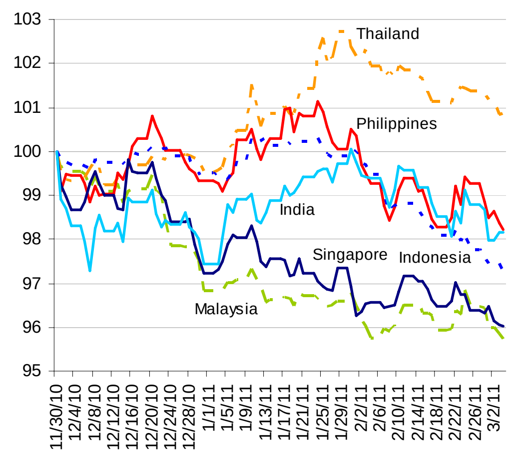

Source: BBVA Research and Bloomberg Index=100

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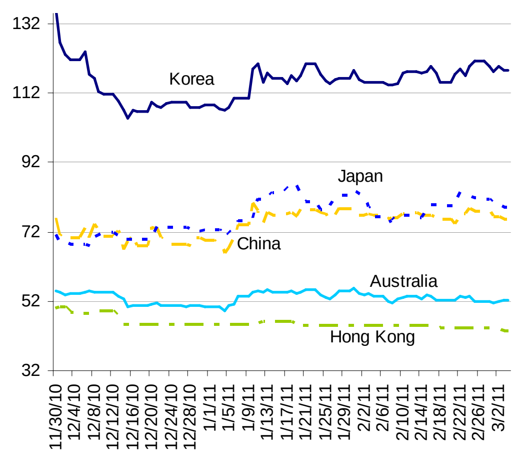

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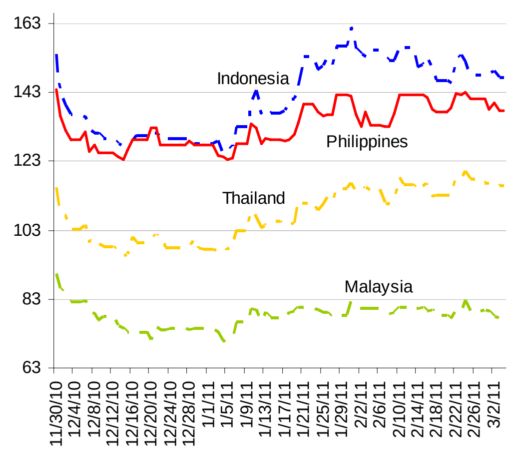

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