BBVA RESEARCH

Weekly Watch

Asia

29 April 2011
Economic Analysis

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Currencies appreciate against USD

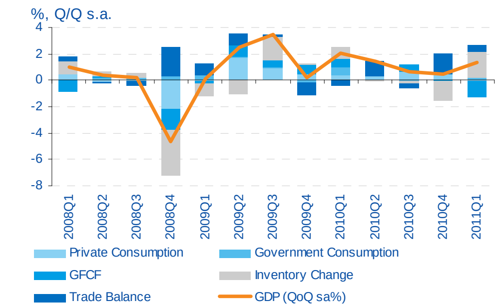
Asian currencies made strong gains this past week on accelerated USD weakness following the Fed's statement of continued lax US monetary policy. Currency gains are also due to strong regional growth indicators. In addition, renewed risks of overheating (inflation) have made central banks more willing to allow appreciation and to tighten monetary policy, despite headwinds from rising oil prices and a deeper-than-expected post-earthquake contraction in Japan. Meanwhile, fiscal difficulties in Japan were underscored this past week by S&P's sovereign outlook from stable to negative, and a sobering economic assessment by the BOJ .

Indicators point to strong growth and overheating risks

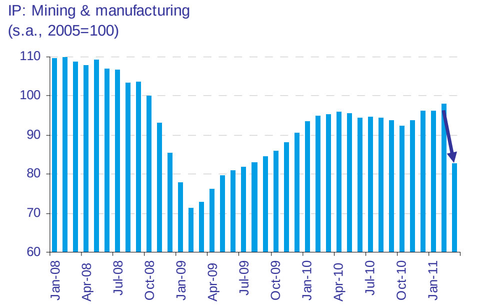
First quarter GDP figures were released in Korea (Chart 1 and Highlights) and Taiwan, showing further strong growth momentum. Industrial production in Singapore (22% y/y vs. consensus: 23.8%y/y) and exports in Hong (21.5% y/y vs. consensus: 20.4%) also showed strength. Overheating pressures, however, are evident from sustained price pressures, with Australia posting higher-than-expected Q1 inflation of 3.3% y/y (consensus: 3.0%) and Singapore posting 5.0% y/y (consensus: 5.2%) in March. We expect India and the Philippines to raise interest rates in their policy meetings next week. At the other end of the spectrum in Japan, post-earthquake industrial production for March plunged by a record -15.3% y/y (Chart 2).

Charts 1 & 2

Korea's Q1 GDP shows strength



A plunge in Japan's industrial production



Source: Bloomberg and BBVA Research

Highlights

Korea's Q1 GDP confirms robust regional growth trends

Korea's preliminary Q1 GDP growth remained strong on robust exports

Keeping tabs on the pace of China's RMB internationalization

RMB trade settlement transactions and offshore deposits grow

Income tax reforms in China to help address income inequality

The proposal would raise the taxable income threshold

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Economic Analysis

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Markets

The USD fell sharply against Asian FX and other major currencies this past week as the US Fed cut its US growth forecasts and vowed to keep rates low for an “extended period”. Within the region, the Australian dollar and Malaysian ringgit saw the biggest gains this week, rising against the USD by 1.5% and 1.1% respectively. The Taiwan dollar (+0.8%), Korean Won (+0.8%), Singapore dollar (+0.6%), Indonesian rupiah (+0.6%), Philippines peso (+0.6%) and Japanese yen (+0.4%) all strengthened further against the USD. In China, the RMB continued its pace of gradual appreciation (+0.3%). Most Asian stock markets, however, lost ground on the weaker US Japanese growth outlooks and worries about monetary tightening in China. China's stock market fell by 4.2%, followed by declines in Australia (-2.1%) and Hong Kong (-1.9%). Markets in Japan, Philippines and Malaysia, on the other hand, saw gains.

Asian central banks intervene to slow currency appreciation

USD weakness, tied to market expectations that the Fed will keep rates low, boosted demand for Asian currencies. Asian FX appreciated rapidly, probably at a pace beyond the comfort zones of many central banks, with Korea, Indonesia, Thailand, Taiwan and Malaysia suspected to have intervened in the FX markets.

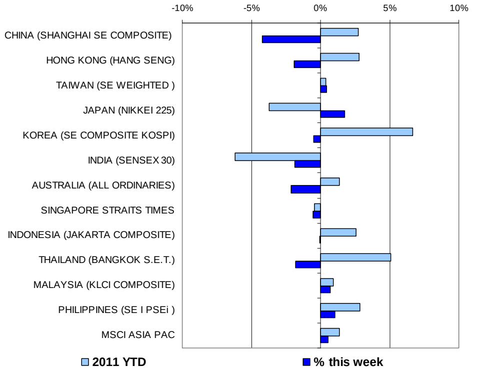
New macro prudential measures may come if USD weakness persists

Asian currencies were already under appreciation pressure on expectations of further monetary tightening to tame inflation. Widening interest rate differentials could draw more capital inflows and buoy currencies further. While monetary authorities in the region may welcome modest appreciation to counter imported inflation, the pace seen in the past week may be too rapid for their taste. If it persists, it could trigger new macro-prudential measures in some countries aiming at curbing short-term speculation, along the lines of what had been seen at the end of last year. For example, the Bank of Korea was reported to be considering the need to tighten banks’ exposure in currency derivatives, while there was a report that the financial regulator in Korea conducted audits to ensure banks’ compliance to their FX limits.

Rumors of Asian central bank reserve diversification gain attention

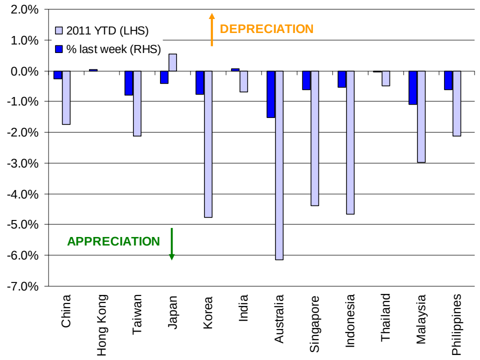
There have been reports that Asian central banks may accelerate reserve diversification out of USD assets following S&P’s cut of the US outlook to negative. A prime example was a report that China’s sovereign wealth fund, the CIC, was to receive new funds from the government to invest in non-USD assets. While Asian monetary authorities may well have reduced the weight of USD assets in their planned reserve holdings, the process of diversification away from the USD is not new, and is likely to be gradual over time. This is because any liquidation of USD assets in large scale could cause significant fall in USD asset prices, which is not in the interest of Asian central banks who are large holders of such assets. Moreover, Europe and Japan are also facing mounting debt problems, and their currencies and assets do not necessarily present superior long-term alternatives to the USD. Amidst FX intervention that might have taken place this week, it would be difficult for Asian central banks to defend their USD/Asia exchange rates while dumping the USD to diversify reserves. The same conclusion could be drawn from US Treasury yields, which have been lower across the curves and indicated no sell-off pressures.

Chart 3
Stock markets



Source: BBVA Research and Bloomberg

Chart 4
Foreign exchange markets



Source: BBVA Research and Bloomberg

Economic Analysis

Highlights

Korea's Q1 GDP confirms robust regional growth trends

Korea's preliminary Q1 GDP growth came in line with expectations at 4.2% y/y. On a seasonally adjusted quarterly basis, growth accelerated to 1.4% (consensus: 1.5% q/q), the fastest rate in three quarters. Robust exports remain the major growth driver, with investment disappointing to the downside in Q1, particularly in the struggling construction sector. Korea's output trends are closely watched as a bellwether for the region given its position in the global supply chain. Together with strong first quarter GDP outturns in China and Singapore, the data for Korea suggest strong growth trends for the region in Q1, despite headwinds from rising oil prices and disruptions from the March 11 earthquake in Japan. Korea's strong growth reading is likely to bolster the case for more interest rate hikes and currency appreciation, in order to tame rising inflation, which reached 4.7% y/y in March, well above the official target range of 2-4%. On the growth outlook, we remain comfortable with our 2011 full year forecast of 4.5%, with only limited disruptions expected from developments in Japan in Q2.

Keeping tabs on the pace of China's RMB internationalization

As has been well publicized, China has embarked on efforts to internationalize the use of its currency, the RMB (see *Economic Watch: RMB Cross-border Trade Settlement*). Since the launching of these efforts in 2008, the value of RMB trade settlement transactions and offshore deposits has increased steadily. According to the latest data for 1Q2011, the value of RMB cross-border settlement transactions amounted to RMB 360.3 billion, an increase of 13.9% over the previous quarter, resulting in an increase in the share of China's trade settled in RMB to 7%, from only 2½% for all of 2010. Meanwhile, the size of RMB deposits in Hong Kong, the main offshore RMB center, have increased further to above RMB 400 billion in February (Chart 5), a doubling since the third quarter of last year alone (much of which, however, may reflect expectations of currency appreciation rather than for use in trade settlement). On the policy front, the authorities are considering a number of steps to deepen the offshore use of RMB further, including: (i) an expansion of the existing pilot program to cover more regions within China (from the current 20 provinces/municipalities); (ii) a facilitation of other offshore RMB centers, especially Singapore; (iii) incentives for the development of additional RMB-denominated financial products in Hong Kong; and most importantly in our view, (iv) a possible easing of restrictions on inflows of RMB for FDI (no details have been announced). RMB bond issuance in Hong Kong is continuing at a steady pace and, for the first time outside of China, Hong Kong's stock exchange is playing host to an RMB-denominated IPO (by the Hui Xian Real Estate Investment Trust).

Income tax reforms in China to help address income inequality

A long-anticipated adjustment in China's income tax threshold and brackets is a step closer to realization. The amendments are aimed at reducing income inequality and boosting consumption, in line with objectives in the new 5-year development plan that emphasize social well-being and economic rebalancing, as well as offsetting higher living costs from rising inflation. Specifically, on April 25, the Standing Committee of the National People's Congress submitted the amendments for public feedback. The proposal would raise the taxable income threshold from RMB2,000 per month (about US$310) to RMB3,000 (about US$460), outpacing inflation and income growth during the same period (the threshold was last changed in March 2008). The amendments would also slightly increase the progressiveness of the tax rate schedule and would reduce the number of brackets from 9 to 7 (the marginal rate for the top bracket would remain at 45%; see Chart 6). The overall impact on consumption and revenues, however, is expected to be limited due to China's relatively low reliance on income tax for revenues (income tax revenues account for about 2½% of GDP according to the IMF) and low rates of tax compliance (especially for high-income brackets). The deadline for public feedback is May 25 and the amendments are likely to become effective in the second half of 2011.

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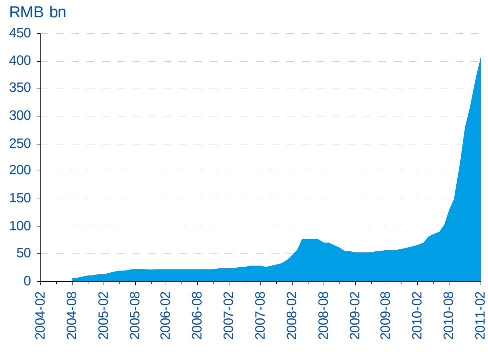
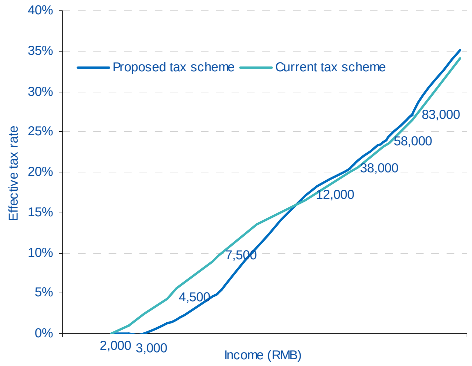
Chart 5
RMB deposits in Hong Kong are surging



Source: BBVA Research and Bloomberg

Chart 6
China seeks a more progressive income tax



Source: BBVA Research and Bloomberg

Calendar Indicators

China	Date	Period	Prior	Cons.
PMI Manufacturing	5/1/2011	APR	53.4	53.8
Hong Kong	**Date**	**Period**	**Prior**	**Cons.**
Retail Sales - Value (YoY)	5/3/2011	MAR	8.60%	16.80%
Indonesia	**Date**	**Period**	**Prior**	**Cons.**
Consumer Price Index (YoY)	5/2/2011	APR	6.65%	6.40%
Total Trade Balance	5/2/2011	MAR	$2401M	$2550M
Exports (YoY)	5/2/2011	MAR	28.90%	24.70%
Total Imports (YoY)	5/2/2011	MAR	26.30%	21.30%
India	**Date**	**Period**	**Prior**	**Cons.**
Exports YoY%	5/2/2011	MAR	49.70%	- -
Imports YoY%	5/2/2011	MAR	21.20%	- -
Japan	**Date**	**Period**	**Prior**	**Cons.**
Vehicle Sales (YoY)	5/2/2011	APR	-37.00%	- -
Malaysia	**Date**	**Period**	**Prior**	**Cons.**
Exports YoY%	5/6/2011	MAR	10.70%	- -
Imports YoY%	5/6/2011	MAR	11.50%	- -
Trade Balance	5/6/2011	MAR	12.64B	- -
Philippines	**Date**	**Period**	**Prior**	**Cons.**
Consumer Price Index (YoY)	5/5/2011	APR	4.30%	4.40%
Korea	**Date**	**Period**	**Prior**	**Cons.**
Consumer Price Index (YoY)	5/2/2011	APR	4.70%	4.60%
Ext Trade - Export (YoY)	5/1/2011	APR	30.30%	23.70%
Ext Trade - Imports (YoY)	5/1/2011	APR	27.90%	25.90%
Ext Trade - Balance in US$ Mln	5/1/2011	APR	3102	3330
Taiwan	**Date**	**Period**	**Prior**	**Cons.**
Consumer Price Index (YoY)	5/5/2011	APR	1.41%	1.40%
Thailand	**Date**	**Period**	**Prior**	**Cons.**
Consumer Price Index (YoY)	5/2/2011	APR	3.14%	3.20%

	Current	Expected
Australia – RBA cash rate target, May 3	**Current**	**Expected**
We expect no change in the interest rates	4.75%	4.75%
India – Repo rate, May 3	**Current**	**Expected**
We expect 25 bps hikes in policy rates	6.75%	7.00%
Malaysia – Overnight rate, May 5	**Current**	**Expected**
We expect no change in the interest rates	2.75%	2.75%
Philippines – Overnight borrowing rate, May 5	**Current**	**Expected**
We expect a 25 bps hike in policy rate	4.25%	4.50%

Calendar Events

China: PMI for April (May 1)

Forecast: 54.2	Consensus: 54.0	Prior: 53.4

Comment: The Purchasing Managers' Index (PMI) will be watched for signs of economic overheating, especially after the first quarter's faster-than-expected GDP growth (9.7% y/y) and rising inflation (5.4%y/y in March). We expect the PMI to rise again in April, following an increase in March, which was the first upturn in 4 months. Market impact: A higher-than-expected reading would enhance expectations of further monetary tightening measures.

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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.	2884.5	-4.2	2.7	0.6
Hong Kong – Hang Seng	23682.8	-1.9	2.8	14.0
Taiwan – Weighted	9007.9	0.4	0.4	11.8
Japan – Nikkei 225	9849.7	1.7	-3.7	-9.8
Korea – Kospi	2187.3	-0.5	6.6	26.5
India – Sensex 30	19242.9	-1.8	-6.2	9.9
Australia – SPX/ASX 200	4810.3	-2.1	1.4	0.5
Singapore – Strait Times	3176.6	-0.6	-0.4	7.4
Indonesia – Jakarta Comp	3798.0	-0.1	2.6	29.8
Thailand – SET	1085.1	-1.8	5.1	44.1
Malaysia – KLCI	1533.2	0.7	0.9	14.8
Philippines – Manila Comp.	4319.5	1.0	2.8	31.0

Last update: Friday, 13.45 Hong Kong time.

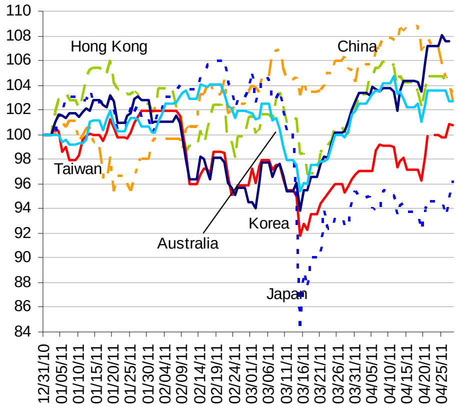
FOREIGN EXCHANGE MARKETS

CURRENCY	Spot	% change over a week	Forward 3-month	Forward 12-month
China (CNY/USD)	6.49	0.26	6.43	6.32
Hong Kong (HKD/USD)	7.77	-0.03	7.8	8
Taiwan (TWD/USD)	28.7	0.79	28.40	27.65
Japan (JPY/USD)	81.6	0.40	81.5	81.2
Korea (KRW/USD)	1072	0.79	1078.91	1093.84
India (INR/USD)	44.4	-0.08	45.1	47
Australia (USD/AUD)	1.09	1.54	1	n.a.
Singapore (SGD/USD)	1.23	0.61	1.23	1.2
Indonesia (IDR/USD)	8576	0.55	8631	8925
Thailand (THB/USD)	29.9	0.03	29.95	30.3
Malaysia (MYR/USD)	2.97	1.11	3.0	3
Philippines (PHP/USD)	42.9	0.62	42.82	42.96

Last update: Friday, 13.45 Hong Kong time.

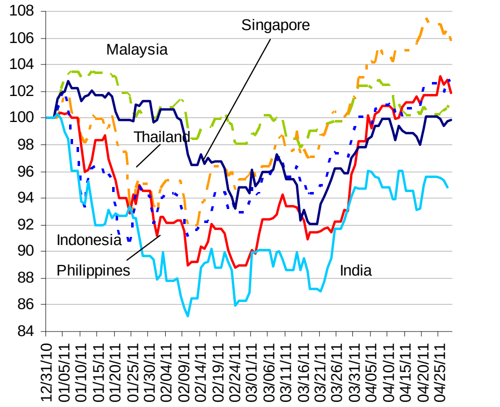
Charts

Chart 6
Stock Markets



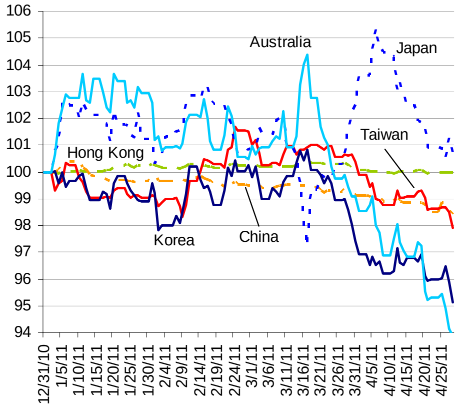
Source: BBVA Research and Bloomberg

Chart 7
Stock Markets



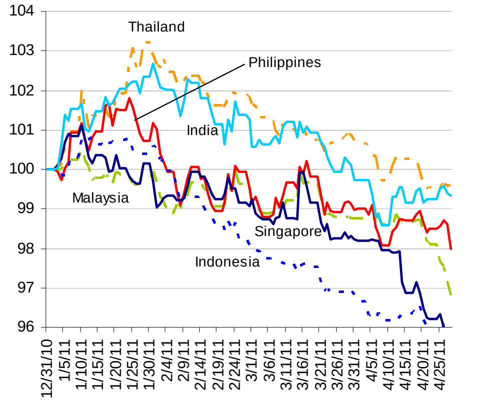
Source: BBVA Research and Bloomberg

Chart 8
Foreign Exchange Markets



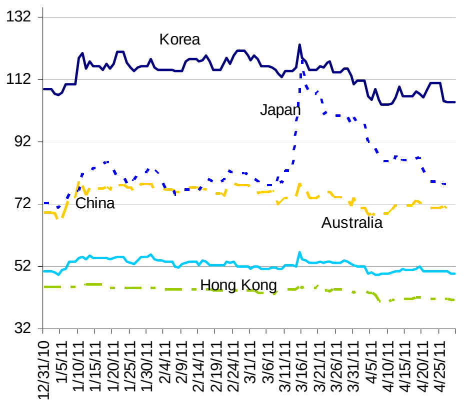
Source: BBVA Research and Bloomberg

Chart 9
Foreign Exchange Markets



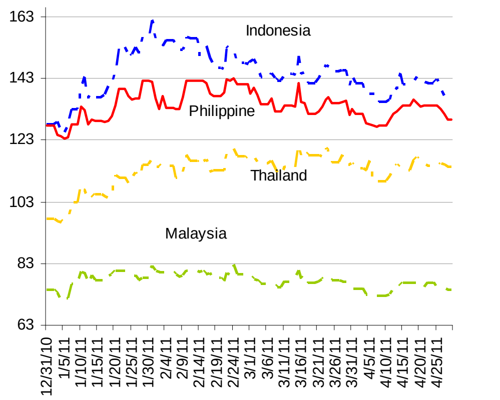
Source: BBVA Research and Bloomberg

Chart 10
Credit Default Swaps



Source: BBVA Research and Bloomberg

Chart 11
Credit Default Swaps



Source: BBVA Research and Bloomberg

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