BBVA | RESEARCH

Weekly Watch
Asia

6 May 2011
Economic Analysis

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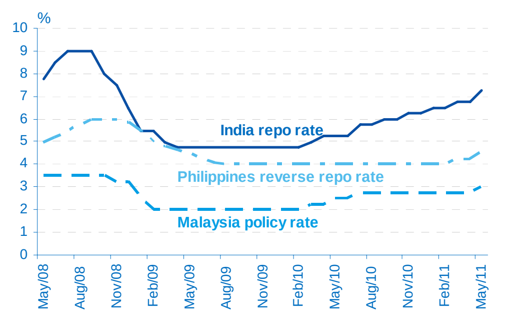
Central banks step up policy tightening

Against the backdrop of robust activity indicators and rising inflation, the region's central banks are stepping up their tightening measures in the battle against inflation. The most aggressive move this week came from India's Reserve Bank (RBI) with a hefty 50bp hike, followed by smaller hikes in Malaysia and the Philippines (see Chart 1 and Highlights). Markets in the region reacted negatively, and were further down today following the global sell-off. China's April PMI reading, released earlier in the week, showed some welcome moderation, helping to allay concerns of a more abrupt tightening (see Highlights).

Despite mixed inflation outturns, upward trend persists

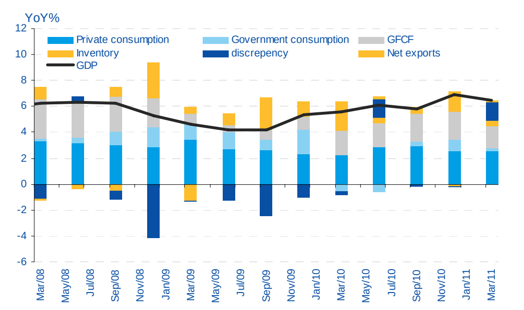
There were a number of monthly inflation releases during the week: Taiwan's (1.3% y/y; consensus: 1.4%), Thailand (4.0% y/y; consensus: 3.2%), the Philippines' (4.5% y/y; consensus: 4.4%), Korea (4.2% y/y; consensus: 4.6%), and Indonesia (6.2% y/y; consensus: 6.4%). While most of the outturns were in line or below expectations (except for Thailand), we believe that underlying inflationary pressures persist with key measures of core inflation continuing to rise. Activity indicators in the region generally remain robust, despite headwinds from Japan and higher oil prices, as underscored this week by Indonesia's Q1 GDP outturn and strong export outturns in Indonesia, India, and Korea.

Charts 1
Asia's central banks step up their rate hikes to counter inflation



Source: BBVA Research and Bloomberg

Chart 2
Indonesia's first quarter GDP growth continues apace



Source: BBVA Research and Bloomberg

Highlights

Asia's battle against inflation intensifies
India surprised markets with a bigger-than-expected rate hike

China's PMI for April shows a welcome moderation
An easing is welcome given overheating risks, with the focus now on next week's data

Japan approves post-quake relief spending as the economic impact mounts
The authorities are seeking to meet relief spending needs without issuing new debt

Economic Analysis

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Markets

The lack of a signal from the ECB of a June rate hike and weak German factory orders triggered a USD corrective bounce, sending risk-sensitive assets sharply lower. Asian stocks declined, and fell for the week, dragging the region's benchmark index to its steepest drop in more than three weeks (Chart 3), following the biggest slump in commodities since 2009. Commodity-related stocks were battered after oil and metals prices dropped sharply Thursday. India extended the biggest losses for the week, following the RBI's aggressive monetary tightening earlier in the week, but rallied today, in contrast to the rest of the region.

China continues to put price stability a top priority

The People's Bank of China (PBoC) issued its quarterly monetary policy report, stating its priority in keeping inflation at bay. While information in the report is largely in line with previous remarks by the PBoC, markets could take it as a sign that China may step up policy tightening.. We do not share this view, and maintain our expectation of a modest and gradual tightening. A gradually strengthening CNY should help to mitigate imported inflation. The debate over Chinese exchange rate policy could heat up again ahead of the US-China Economic and Strategic Dialogue next week and G20 finance minister's meeting later this month.

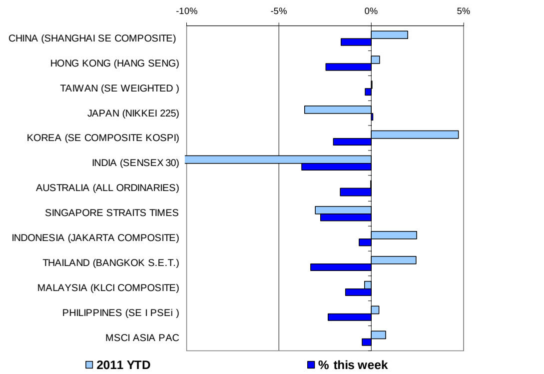
Diverging monetary policy

As the Fed sent out signals that it is in no rush to hike rates, three Asian central banks tightened their policies this week to keep inflation risks at bay (see Highlights). Two out of three came as a surprise - Bank Negara Malaysia resumed rate hikes earlier than expected and Reserve Bank of India hiked rates by more than what market was positioning for. The move marks the dichotomy between Asia's and the Fed's policy, reflecting differences in economic cycles. However, their impacts on Asia's FX were overwhelmed by USD correction this week. But in circumstances when the USD is neutral, we think the rate hikes should have boosted the MYR as they are not completely in the price. On the other hand, INR should have been under depreciation pressure as higher interest rates in the near term could reduce the appeal of Indian equities, the major category of India's portfolio inflows.

Korea considers to diversify FX reserves by holding CNY Assets

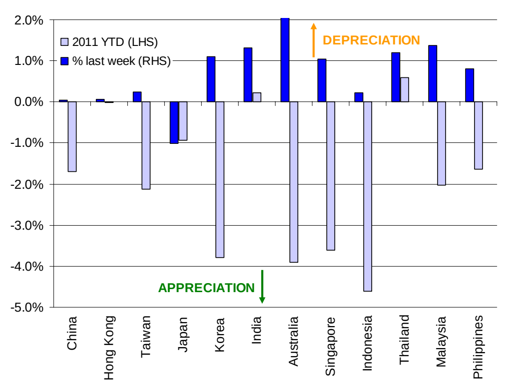
Amidst talks of Asian central bank diversification of reserves out of the USD, the Bank of Korea (BoK) was reported to be considering to place some of its record-high USD307 billion foreign reserves in CNY-denominated assets. Any such move would be limited in scale given the small pool of available CNY assets and difficulties of entering the Chinese market (Beijing has so far granted quotas totaling about $21bn to just over 100 qualified foreign investors, including three central banks – in Norway, Hong Kong and Malaysia.). Over the much longer run, CNY assets should gain importance in Asian central bank portfolios given the appeal of CNY appreciation and policy support by China's authorities to internationalize the currency.

Chart 3
Stock markets



Source: BBVA Research and Bloomberg

Chart 4
Foreign exchange markets



Source: BBVA Research and Bloomberg

Highlights

Asia's battle against inflation intensifies

This past week saw policy rate hikes in India, Malaysia, and the Philippines in their ongoing responses to inflation pressures (see Chart 1). India's move was the most noteworthy, with a larger-than-expected 50bp rate hike to tame stubbornly high inflation (9.0% y/y in March), that has increasingly been fed by demand-side, rather than just supply-side factors. The move was India's ninth interest rate hike since the tightening cycle began in March 2010 (cumulative hikes of 275bps), and a departure from the central bank's "baby-step" approach of moving in 25bp increments (it was only the second 50bp increase in the current tightening cycle, with the last such move in July 2010). The RBI signaled that it is sacrificing near-term growth to maintain price stability over the longer term. The benchmark repo rate now stands at 7.25%. Similarly, rising inflation pressures prompted the Philippines this past week to raise rates for a second time, by 25bps to 4.50% (in line with expectations), and in Malaysia the central bank unexpectedly hiked by another 25bp hike to 3.00% (the first hike since July 2010) and raised reserve requirements by 100bps to 3% (the second consecutive monthly increase). We expect further monetary tightening during the remainder of the year, with 50bps in additional hikes each in India, the Philippines and Malaysia. We believe that rate hikes would be even larger were it not for expected growth headwinds from high commodity prices.

China's PMI for April shows a welcome moderation

Following an increase in March (the first in four months), and a stronger-than-expected Q1 GDP outturn, data released this past week for China's April Purchasing Manager's Index (PMI) showed a moderation in growth momentum. The PMI declined to 52.9%, lower than expected (BBVA: 54.2%; consensus: 54.0%) and down from the March reading of 53.4% (Chart 5). Importantly, the PMI reading remains firmly in the expansion zone (+50). The moderation should, in principle, help allay concerns of overheating. The decline was due in large part to a slip in new orders to 53.8% from 55.2% in March, and a decline in export orders to 51.3% from 52.5% in March. Production also moderated to 55.7% from 55.3% in March. Market-watchers will be looking to a batch of monthly data due next week (see Weekly Indicator) on April inflation, investment, retail sales and credit growth for further signs of moderation. With inflation in March having accelerated further, to 5.4%y/y (well above the authorities' comfort level of 4%), and Q1 GDP of 9.7% y/y, risks are skewed toward overheating, which has prompted further monetary tightening by the authorities in recent weeks. Market sentiment has been swinging between concerns of overheating on the one hand, and of a hard landing on the other. Our baseline of a soft landing remains in tact.

Japan approves post-quake relief spending as the economic impact mounts

Japan's parliament early this past week approved a ¥ 4 trillion (US$ 49.3 billion) disaster relief budget, as expected, to finance the construction of temporary housing, repair infrastructure, and provide support to businesses affected by the disaster. The measures are likely to be the first in a series of new spending initiatives for post-disaster reconstruction. Importantly, the current relief package is to be financed by funds previously earmarked for other purposes, and will not involve additional debt issuance. Japan's fiscal challenges were underscored last week by S&P's downgrade of the sovereign credit outlook from stable to negative. The fiscal position is expected to remain under pressure given the scale of spending needs in the aftermath of the earthquake. Meanwhile, the Bank of Japan last week revised down the growth outlook for the coming year given the disaster's larger-than-expected impact on supply chains, and on consumer and business confidence. The limited set of indicators so far all point to a large contraction in Q1 and Q2, with plunges in March/April industrial production, retail and vehicle sales, and exports (Chart 6). At its policy meeting last week the BoJ kept its monetary policy unchanged, including its low policy rate (0%-0.1%) and an asset-purchase program (10 trillion yen) and loan facility (30 trillion yen). However, the BoJ has signaled it may ease policy further, possibly at its next monthly meeting later this month. We expect the economy to rebound strongly in the second half, with overall GDP growth for 2011 of 0.5%, down from our pre-quake estimate projection of 1.5%.

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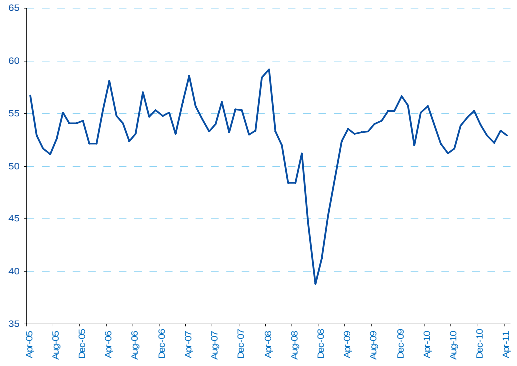
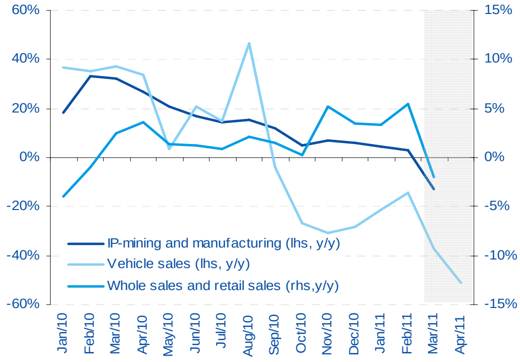
Chart 5
China's PMI in April shows a welcome moderation



Source: BBVA Research and Bloomberg

Chart 6
Post-quake activity indicators in Japan plunge



Source: BBVA Research and Bloomberg

Calendar Indicators

Australia	Date	Period	Prior	Cons.
Trade Balance	10-May	MAR	-205M	- -
Unemployment Rate	12-May	APR	4.90%	- -
China	**Date**	**Period**	**Prior**	**Cons.**
Trade Balance (USD)	10-May	APR	$0.14B	$4.35B
Exports YoY%	10-May	APR	35.80%	29.50%
Imports YoY%	10-May	APR	27.30%	28.90%
Consumer Price Index (YoY)	11-May	APR	5.40%	5.20%
Industrial Production (YoY)	11-May	APR	14.80%	14.60%
Retail Sales (YoY)	11-May	APR	17.40%	17.50%
New Yuan Loans	11-15 MAY	APR	679.4B	700.0B
Hong Kong	**Date**	**Period**	**Prior**	**Cons.**
GDP (YoY)	13-May	1Q	6.20%	5.40%
India	**Date**	**Period**	**Prior**	**Cons.**
Industrial Production YoY	12-May	MAR	3.60%	- -
Japan	**Date**	**Period**	**Prior**	**Cons.**
Adjusted Current Account Total	12-May	MAR	¥1209.8B	¥972.2B
Current Account Balance YOY%	12-May	MAR	3.00%	-32.70%
Trade Balance - BOP Basis	12-May	MAR	¥723.3B	¥303.4B
Machine Tool Orders (YoY)	12-May	APR P	49.60%	- -
Malaysia	**Date**	**Period**	**Prior**	**Cons.**
Industrial Production YoY	11-May	MAR	5.00%	3.40%
GDP YoY%	13-18 MAY	1Q	4.80%	- -
Philippines	**Date**	**Period**	**Prior**	**Cons.**
Total Exports (YoY)	10-May	MAR	8.20%	7.50%
Singapore	**Date**	**Period**	**Prior**	**Cons.**
Retail Sales (YoY)	13-May	MAR	-12.10%	-2.40%
Korea	**Date**	**Period**	**Prior**	**Cons.**
Unemployment Rate (SA)	11-May	APR	4.00%	3.80%
Taiwan	**Date**	**Period**	**Prior**	**Cons.**
Total Trade Bal in US$ Billion	9-May	APR	$1.77B	$1.70B
Total Exports (YoY)	9-May	APR	16.70%	17.50%
Total Imports (YoY)	9-May	APR	16.70%	23.10%

Indicator of the Week: China CPI for April (May 11)

Forecast: 5.2% y/y	Consensus: 5.2% y/y	Prior: 5.4% y/y

Comment: Given risks of overheating, headline inflation will be closely watched, along with a batch of other monthly indicators for April including retail sales, fixed investment, industrial production, and credit growth. We expected inflation to ease in April due to a sharp decline in food prices from their high levels in March. Following a softer PMI reading for April, we also anticipate a moderation in accompanying activity indicators. Market impact: Sentiment will be easily swayed between concerns of overheating and more policy tightening on the one hand if inflation turns out higher-than-expected, and by risks of a hard-landing on the other hand if the data are lower than expected.

Calendar Events

	Current	Expected
Indonesia – Bank of Indonesia Reference Rate, May 12	**Current**	**Expected**
We expect no change in the interest rates	6.75%	6.75%
Korea – Bank of Korea 7-Day Repo Rate, May 13	**Current**	**Expected**
We expect a 25 bp hike in the 7-Day Repo Rate	3.00%	3.25%

Markets Data

STOCK MARKETS

INDEX	Last price	% change over a week	Year to date	% Change over 1 Y
China – Shanghai Comp.	2863.9	-1.6	2.0	4.5
Hong Kong – Hang Seng	23146.5	-2.4	0.5	15.0
Taiwan – Weighted	8977.2	-0.3	0.1	18.4
Japan – Nikkei 225	9859.2	0.1	-3.6	-10.8
Korea – Kospi	2147.5	-2.0	4.7	24.9
India – Sensex 30	18418.6	-3.7	-10.2	8.4
Australia – SPX/ASX 200	4743.0	-1.7	0.0	3.7
Singapore – Strait Times	3092.1	-2.8	-3.1	8.9
Indonesia – Jakarta Comp	3794.5	-0.7	2.5	35.0
Thailand – SET	1057.7	-3.3	2.4	32.7
Malaysia – KLCI	1513.4	-1.4	-0.4	13.6
Philippines – Manila Comp.	4219.1	-2.3	0.4	33.2

Last update: Friday, 16.15 Hong Kong time.

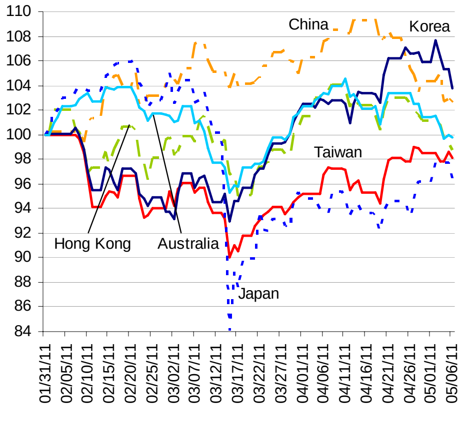
FOREIGN EXCHANGE MARKETS

CURRENCY	Spot	% change over a week	Forward 3-month	Forward 12-month
China (CNY/USD)	6.50	-0.05	6.46	6.35
Hong Kong (HKD/USD)	7.77	-0.07	7.8	8
Taiwan (TWD/USD)	28.7	-0.23	28.49	27.81
Japan (JPY/USD)	80.4	1.05	80.3	80.1
Korea (KRW/USD)	1083	-1.09	1092.80	1107.32
India (INR/USD)	44.8	-1.29	45.5	48
Australia (USD/AUD)	1.06	-2.94	1	n.a.
Singapore (SGD/USD)	1.24	-1.03	1.24	1.2
Indonesia (IDR/USD)	8583	-0.23	8676	8981
Thailand (THB/USD)	30.2	-1.19	30.33	30.6
Malaysia (MYR/USD)	3.00	-1.35	3.0	3
Philippines (PHP/USD)	43.1	-0.81	43.09	43.25

Last update: Friday, 16.15 Hong Kong time.

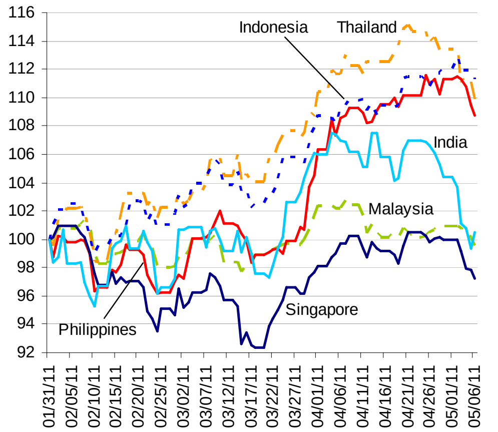
Charts

Chart 6
Stock Markets



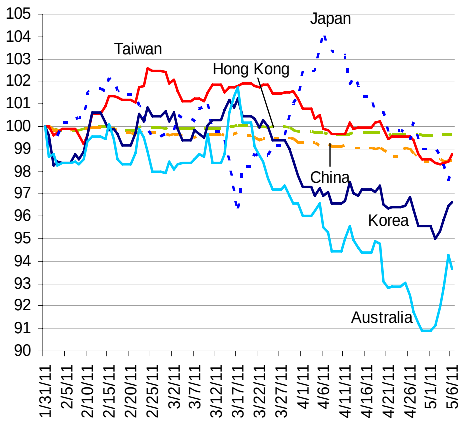
Source: BBVA Research and Bloomberg

Chart 7
Stock Markets



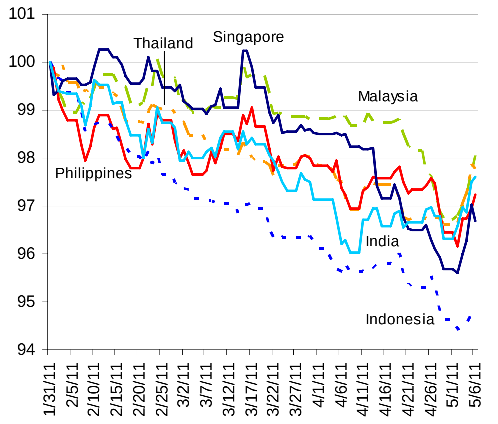
Source: BBVA Research and Bloomberg

Chart 8
Foreign Exchange Markets



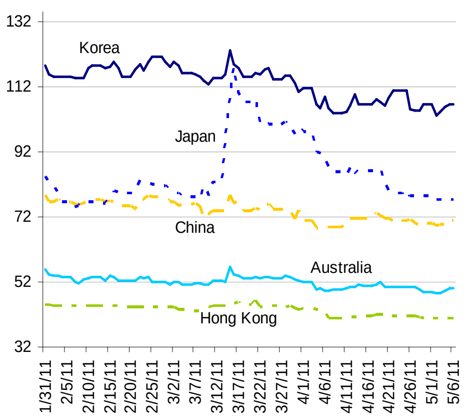
Source: BBVA Research and Bloomberg

Chart 9
Foreign Exchange Markets



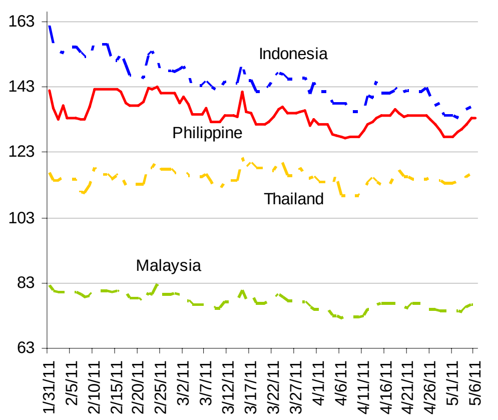
Source: BBVA Research and Bloomberg

Chart 10
Credit Default Swaps



Source: BBVA Research and Bloomberg

Chart 11
Credit Default Swaps



Source: BBVA Research and Bloomberg

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