BBVA | RESEARCH

Weekly Watch

Asia

3 June 2011
Economic Analysis

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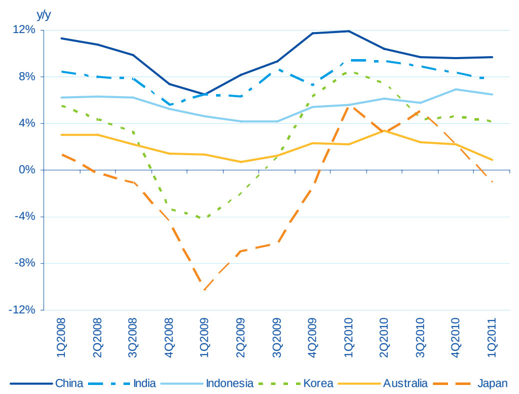
Growth moderating amidst high inflation

As flagged in recent publications (*Asia Outlook*), we have been expecting a slowdown in Asia's growth momentum on headwinds from rising oil prices, supply disruptions in Japan, and financial market tensions in Europe. Recent indicators bear this out. Industrial production in Korea and PMI in China (Highlights) point to moderating trends, and first quarter GDP in India disappointed to the downside (Chart 1). That said, we expect the slowdown to be temporary, confined mainly to the second quarter, and it could provide some welcome relief from overheating pressures. Nevertheless growth figures remain strong, as does inflation which, in spite of some easing, is still above target ranges in most economies. To counter inflation pressures, the Thai authorities raised interest rates this past week for a forth time this year, to 3.0% (Chart 2).

Slowing momentum

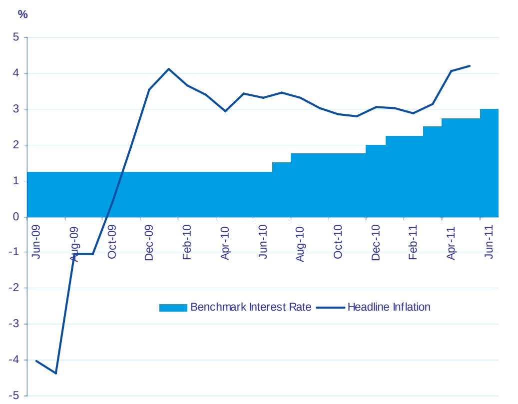
First quarter GDP in India edged down to 7.8% y/y, from 8.2% in the previous quarter, and lower than expectations (Highlights). Meanwhile, Australia's economy shrank -1.2% (q/q), in line with expectations (consensus: -1.1% q/q) while the Philippines grew by a lower-than-expected 4.9% (consensus: 5.4%) from a previous 7.1%. Elsewhere in the region, inflation quickened, including in Thailand, Korea, and Indonesia.

Chart 1
First quarter GDP outturns where strong, though moderating in a few cases



Source: BBVA Research and Bloomberg

Chart 2
Thailand hikes interest rates again



Source: BBVA Research and Bloomberg

Highlights

China: Moderation in May PMI

The latest PMI outturn signals a healthy slowdown

India: first quarter GDP growth eases below 8% y/y

Growth is slowing in India, but we expect more interest rate hikes to counter inflation

Hong Kong banks to undergo stress tests

The HKMA is keeping a watchful eye on rapid credit growth

Economic Analysis

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Markets

Concerns over global growth slowdown and Greek debt default battered stock markets, with regional index broadly lower compared to previous week close, driving it index to its longest string of weekly losses since October 2008. In FX markets, tentative signs of labor market sluggishness reinforced expectation that the Fed may keep its ultra-loose monetary policy for longer. As such, the USD index ended lower by 2.1%, allowing most Asian currencies to post modest gains against the USD this week.

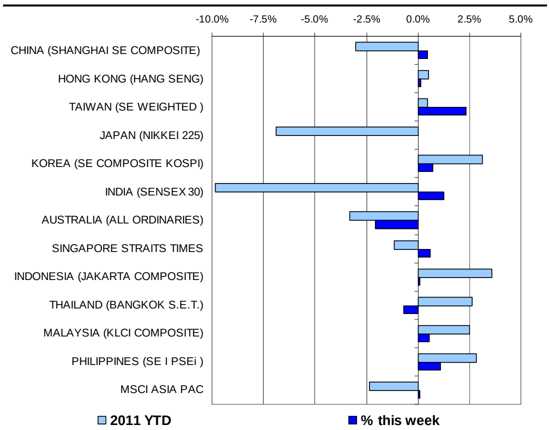
Markets Preoccupied by Moderating Growth Outlook

Data out of the region broadly suggested slower growth momentum in the second quarter, which fell in line with the moderation trend in global PMI. As markets shifted attention from growth to inflation, government yields in major Asian bond markets fell and bond swap spreads were tighter. Markets appeared to start pricing out some rate hikes expected this year and next, despite elevated inflation. It seems to us the market has over-reacted on one-month observations. Second-quarter setback could be temporary, as highlighted in our Quarterly Report. As long as Asia could resume growth in the second half of the year, Asian central banks will have to tighten policy to keep inflation expectation anchored. Take Korea as an example. While CPI for May fell slightly, it was still 100 bps well above the BoK's mid-target of 3.0%. Moreover, core inflation continued to edge up, and slacks in the labor markets are fairly limited. We see needs for the BoK to hike rates gradually to keep inflation at bay, and will likely to deliver this month.

Data Shows Foreign Buying of Asia's Fixed Income Remains Strong

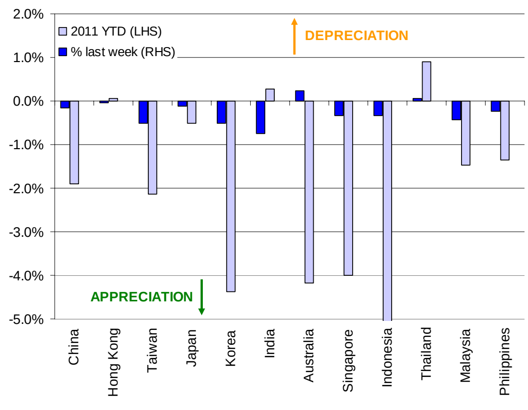
Latest data on foreign holdings of bonds in Malaysia and Indonesia showed that foreign investors continued to add Asian bonds to their fixed income portfolio. Total holdings in Malaysia climbed from MYR 146.8 bn in March to MYR 173.1 bn in April. In Indonesia, foreign investors bought IDR4.5 trillion government bond in May, bringing the total sum to IDR226 trillion. Demand remained strong, supporting the latest forecast upgrade by IIF on capital flows to emerging markets. Higher yields and strong fundamentals that stand in sharp contrast with US and many debt-ridden European countries world may have underpinned demand. Better growth dynamics coupled with strong capital flows will continue to support Asian currency appreciation trend in the medium term in our view.

Chart 3
Stock markets



Source: BBVA Research and Bloomberg

Chart 4
Foreign exchange markets



Source: BBVA Research and Bloomberg

Economic Analysis

Highlights

China: Moderation in May PMI heralds a healthy trend toward a soft landing

China's Purchasing Manager Index (PMI) for May further declined to 52.0% from 52.9% in April, in line with our expectations, but slightly higher than market consensus (BBVA: 51.9%; consensus: 51.6%). The outturn was the third straight monthly decline from March. Encouragingly, the trend of moderation continues to be mild, indicating that the probability of an abrupt slowdown (or "hard landing") is quite small. That said, the PMI is still within the expansion zone (+50). Almost all the main subcomponents (including production, new orders, employment, supplier delivery and raw material inventory) declined from the previous month, to varying degrees. In particular, new orders (with a weight of 30%) and raw materials inventory (10%) declined by 1.7 and 2.5 percentage points respectively. The decline in the latter suggests that firms have begun to destock. The outturn should help reinforce investors' confidence that China can achieve a soft-landing, as the authorities continue seeking to avert overheating and tame inflation through monetary tightening. Our full-year GDP growth forecast remains 9.4%, consistent with a soft-landing base scenario. On the policy front, we anticipate further gradual monetary tightening in the form of interest rate hikes and increases in the required reserve ratio (RRR) in the months ahead.

India: First quarter GDP growth eases below 8% y/y

Growth surprises in 1Q11 across many Asian economies have been significantly positive. In this context, data released this past week shows India to be an exception, with real GDP growth easing to 7.8 % y/y (below consensus of 8.2% y/y), and from 8.3% in 4Q10. The latest outturn is still one of the highest across among the world's fast-growing emerging market economies, and is still in line with our expectations of a stable trend growth rate of 8.1% y/y for all of 2011. On a seasonally adjusted basis, we estimate that GDP grew 2.4% q/q from a 0.11% fall in 4Q10. The moderation was mainly driven by a significant pullback in investment activity (+0.4% y/y vs. +7.8% in 4Q10), led by supply bottlenecks such as project disputes and delays, parliamentary indecision and governance issues. A tightening policy stance amidst rising price pressures coupled with high and volatile global commodity prices also weighed on investment sentiment. Growth was buoyed by still-strong consumption demand (+8.0% y/y in 1Q11) led by rising income levels, along with pent-up government expenditure. Meanwhile, the strong global industrial cycle in 1Q11 boosted export growth (+25% y/y). Consumption and net exports together contributed 83% of GDP growth in 1Q11. From a supply perspective, growth continued to be led by the services sector, while industrial growth was dragged down due by sluggish investment activity. Agriculture GDP posted reasonable gains (+7.5% y/y), driven by a favorable base effects and bumper winter crop produce. Notwithstanding the ongoing growth moderation, we maintain our view of another 50 bps rate hike in 2011 as the RBI remains focused on containing high inflation, even at the cost of sacrificing some near term growth.

Hong Kong banks to undergo stress tests

On concerns of rapid credit growth, the Hong Kong Monetary Authority (HKMA) at the end of May imposed a requirement on commercial banks to undergo stress tests to gauge their ability to weather a potential outflow of liquidity. The stress scenarios are expected to be based on an assumed capital outflow amounting to half of HK$ 1.38 trillion in customer deposits over a six-to-twelve month horizon. This move reflects the authorities' increasing awareness of potential risks of fast credit expansion since mid-2010. By end-March, the local currency loan-to-deposit ratio for Hong Kong banks had reached about 82%, compared to 71% in early 2010 (the ratio reached 90-100% in some smaller banks). The increase in the ratio is mainly due to (1) a surge in lending to mainland Chinese companies as China undergoes domestic credit tightening, (2) strong domestic demand for mortgages under a low interest rate environment, and (3) slow growth in HKD deposits as depositors increasingly switch to higher yielding foreign currencies, including Renminbi (RMB) deposits, which have almost tripled since last August and accounted for 7.6% of total bank deposits in Hong Kong as of April.

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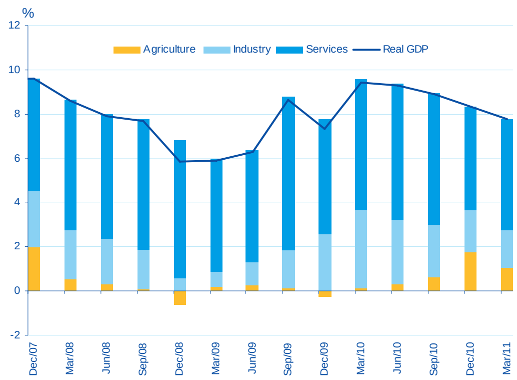
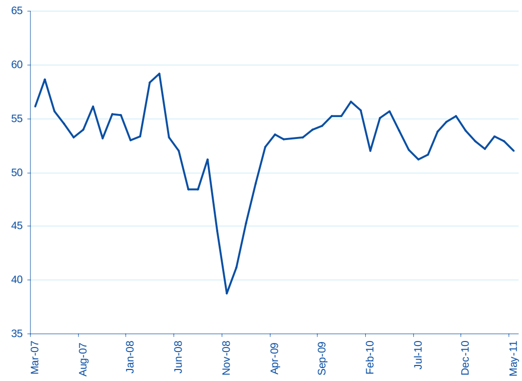
Chart 5
India's first quarter GDP eases



Source: BBVA Research and Bloomberg

Chart 6
China's PMI signals a healthy moderation



Source: BBVA Research and Bloomberg

Calendar Indicators

Australia	Date	Period	Prior	Cons.
Unemployment Rate	09-Jun	MAY	4.90%	- -
China	**Date**	**Period**	**Prior**	**Cons.**
Trade Balance (USD)	10-Jun	MAY	$11.42B	$17.00B
Exports YoY%	10-Jun	MAY	29.90%	21.80%
Imports YoY%	10-Jun	MAY	21.80%	22.30%
Actual FDI (YoY)	10-15 JUN	MAY	15.20%	- -
Indonesia	**Date**	**Period**	**Prior**	**Cons.**
Money Supply - M2 (YoY)	07-10 JUN	APR	16.00%	- -
India	**Date**	**Period**	**Prior**	**Cons.**
Industrial Production YoY	10-Jun	APR	7.30%	- -
Japan	**Date**	**Period**	**Prior**	**Cons.**
Japan Money Stock M2 YoY	08-Jun	MAY	2.70%	2.70%
Adjusted Current Account Total	08-Jun	APR	¥752.7B	¥266.0B
Current Account Balance YOY%	08-Jun	APR	-34.30%	-83.50%
Trade Balance - BOP Basis	08-Jun	APR	¥240.3B	-¥379.0B
Machine Tool Orders (YoY)	09-Jun	MAY P	32.30%	- -
Malaysia	**Date**	**Period**	**Prior**	**Cons.**
Industrial Production YoY	09-Jun	APR	2.40%	- -
Manufacturing Sales Value YoY%	09-Jun	APR	14.10%	- -
Philippines	**Date**	**Period**	**Prior**	**Cons.**
Consumer Price Index (YoY)	07-Jun	MAY	4.50%	5.00%
Total Exports (YoY)	10-Jun	APR	4.00%	- -
Korea	**Date**	**Period**	**Prior**	**Cons.**
South Korea Money Supply M2	09-Jun	APR	4.30%	- -
Producer Price Index (YoY)	10-Jun	MAY	6.80%	- -
Taiwan	**Date**	**Period**	**Prior**	**Cons.**
CPI YoY%	07-Jun	MAY	1.34%	1.60%
Total Trade Bal in US$ Billion	08-Jun	MAY	$2.96B	$2.53B
Total Exports (YoY)	08-Jun	MAY	24.60%	7.40%
Total Imports (YoY)	08-Jun	MAY	25.70%	11.10%
Vietnam	**Date**	**Period**	**Prior**	**Cons.**
Domestic Vehicle Sales (YoY)	6-10 JUN	MAY	-2.60%	- -

Indicator of the Week: India Industrial Production for April (June 10)

Forecast: 5.5% y/y	Consensus: not available yet	Prior: 7.3% y/y

Comment: India has been an example in Asia of moderating growth trends. In a surprising outturn, however, India's industrial production (IP) growth rebounded in March, raising the question whether the slowdown has bottomed out. In this regard, April IP will be important, although the index is notoriously volatile. We expect growth to remain steady in April, supported by robust exports, consumption demand, inventory restocking and higher infrastructure output. Market impact: A lower outturn would dent sentiment, and reduce expectations of aggressive interest rate hikes.

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Calendar Events

	Current	Expected
Australia – RBA Cash Target, June 7	Current	Expected
We expect no change in the interest rates	4.75%	4.75%
Indonesia – Bank Indonesia Reference Rate, June 9	Current	Expected
We expect no change in the interest rates	6.75%	6.75%
Korea – Monetary Policy Meeting, 7-Day Repo Rate, June 10	Current	Expected
We expect a hike of 25 bp 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.	2722.3	0.5	-3.1	6.6
Hong Kong – Hang Seng	23152.6	0.1	0.5	17.0
Taiwan – Weighted	9016.2	2.3	0.5	22.5
Japan – Nikkei 225	9524.2	0.0	-6.9	-3.9
Korea – Kospi	2115.5	0.7	3.1	27.3
India – Sensex 30	18494.2	1.2	-9.8	8.6
Australia – SPX/ASX 200	4587.6	-2.1	-3.3	2.3
Singapore – Strait Times	3153.9	0.6	-1.1	12.9
Indonesia – Jakarta Comp	3833.8	0.0	3.5	40.2
Thailand – SET	1059.8	-0.7	2.6	38.4
Malaysia – KLCI	1557.2	0.6	2.5	20.3
Philippines – Manila Comp.	4320.4	1.1	2.8	28.8

Last update: Friday, 11.15 Hong Kong time.

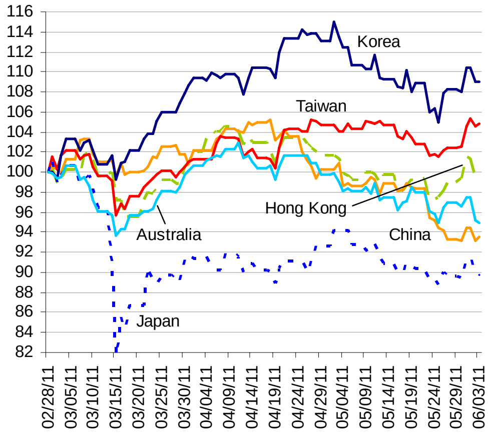
FOREIGN EXCHANGE MARKETS

CURRENCY	Spot	% change over a week	Forward 3-month	Forward 12-month
China (CNY/USD)	6.48	0.15	6.46	6.36
Hong Kong (HKD/USD)	7.78	0.03	7.8	8
Taiwan (TWD/USD)	28.7	0.52	28.50	27.90
Japan (JPY/USD)	80.7	0.10	80.7	80.4
Korea (KRW/USD)	1077	0.51	1083.36	1098.36
India (INR/USD)	44.8	1.07	45.5	47
Australia (USD/AUD)	1.07	-0.26	1	n.a.
Singapore (SGD/USD)	1.23	0.33	1.23	1.2
Indonesia (IDR/USD)	8537	0.33	8619	8898
Thailand (THB/USD)	30.3	-0.07	30.50	30.9
Malaysia (MYR/USD)	3.02	0.42	3.0	3
Philippines (PHP/USD)	43.2	0.23	43.26	41.98

Last update: Friday, 11.15 Hong Kong time.

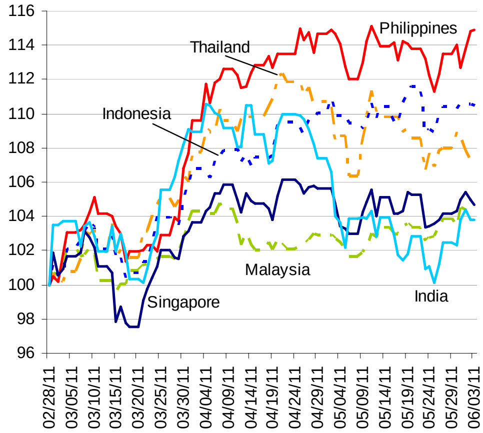
Charts

Chart 6
Stock Markets



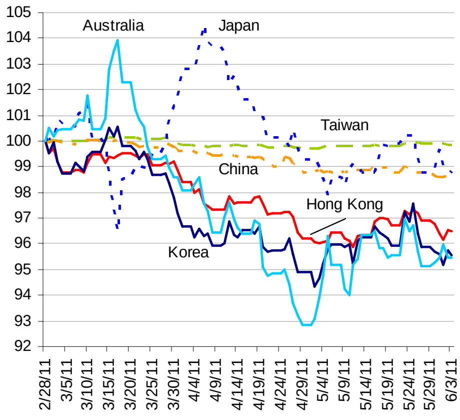
Source: BBVA Research and Bloomberg

Chart 7
Stock Markets



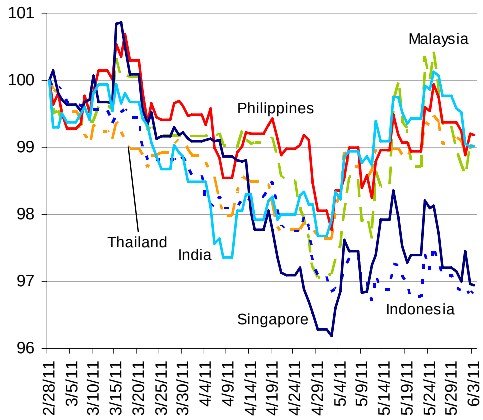
Source: BBVA Research and Bloomberg

Chart 8
Foreign Exchange Markets



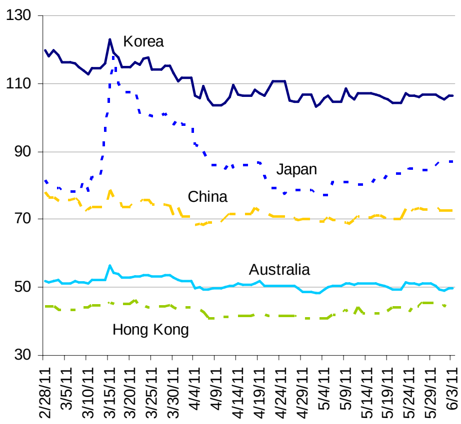
Source: BBVA Research and Bloomberg

Chart 9
Foreign Exchange Markets



Source: BBVA Research and Bloomberg

Chart 10
Credit Default Swaps



Source: BBVA Research and Bloomberg

Chart 11
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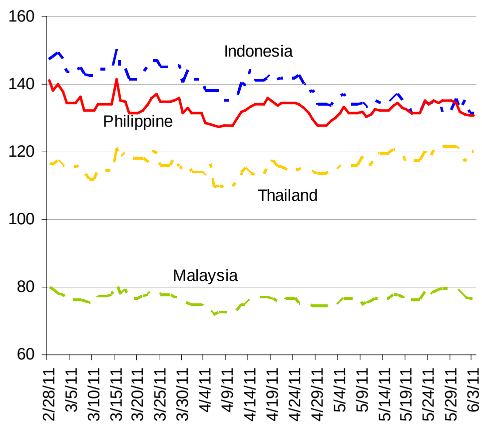

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