BBVA RESEARCH

Weekly Watch

Asia

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Economic Analysis

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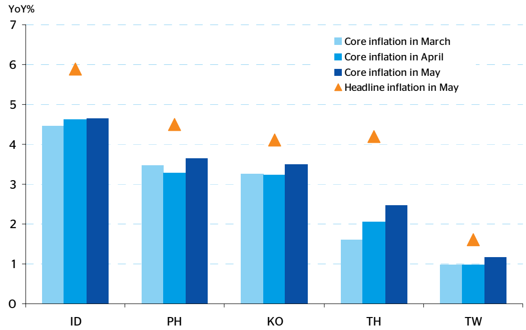
Are central banks softening on inflation?

Headline inflation has either already peaked, or is close to doing so, in a number of countries in the region thanks to easing food and energy prices. This, together with moderating trends in global growth and domestic demand, has led several central banks to begin signaling a softer stance on inflation. For example, central banks in Indonesia, Australia and New Zealand stood pat on interest rates this past week (Chart 2), with their statements showing less concern about inflation risks . Nevertheless, core inflation is continuing to rise (see Highlights), reflecting strong demand side pressures. This was an important motivation for the Bank of Korea in raising rates this week to 3.25%, thus continuing the normalization of monetary policy, which is still accommodative. We continue to expect further rate hikes across the region, albeit at a gradual pace (see Asia Outlook).

Latest indicators point to moderating growth and easing headline inflation

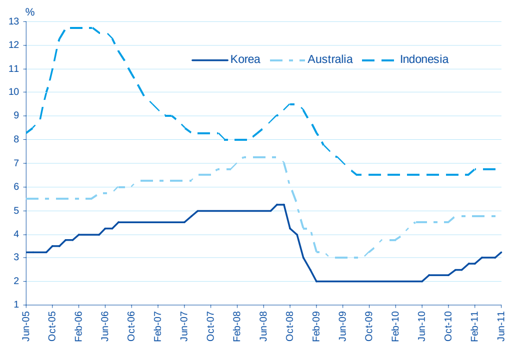
Industrial production in India (4.4% y/y vs. consensus 5.5%) and Malaysia (-2.2% y/y vs. consensus 2.5%) eased, as did exports in China (19.4% y/y) and Taiwan (9.5% y/y), both broadly in line with expectations. Also, Korea and Japan revised down their 1Q GDP figures. All of this is in line with our expectations of temporary moderating growth trends due to headwinds from higher oil prices and post-earthquake developments in Japan. Meanwhile, headline inflation shows signs of easing, although it picked up slightly in the Philippines (4.5% y/y vs. consensus 5.0% y/y) and Taiwan (1.7% y/y; consensus: 1.6%). Next week, the focus will be on a batch of data from China (Highlights) and inflation in India, which will also hold its monthly monetary meeting, where we expect another rate hike, although it will be a close call given easing production and investment indicators.

Chart 1
Core inflation rates continues to rise



Source: BBVA Research and Bloomberg

Chart 2
Korea hikes interest rates while Indonesia and Australia stay pat



Source: BBVA Research and Bloomberg

Highlights

China's authorities reported to be seeking solution to local government debts

The central government is acting to head off risks posed by local government debt

Core inflation continues to rise, even has headline inflation eases

Easing commodity prices are leading to a decline in headline inflation rates

China's trade data supports a soft landing, with activity data awaited

Robust May export and import data reveal still strong external and domestic demand

Economic Analysis

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Growth fears, higher oil prices, uncertainties from the Greek debt situation and anticipation of imminent tightening by China continued to weigh on sentiment. Elevated risk aversion sent Asian equities broadly lower (Chart 3), while regional currencies were essentially flat compared to last week's close.

JPY dips below 80 with no intervention

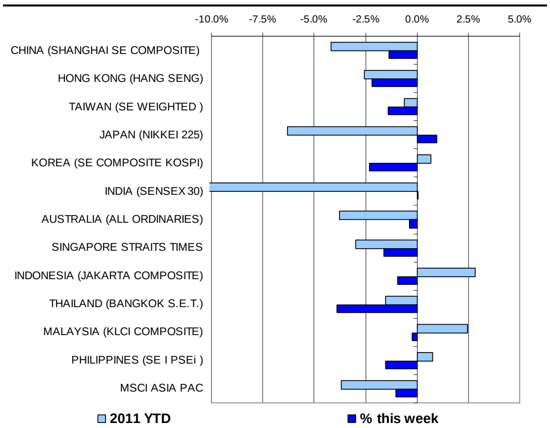
USDJPY dipped below 80 Wednesday, for the first time since early May, as 2-year US treasury fell to around 0.4%. As we highlighted previously, the pair is still largely a play on US rates. As such, it faced significant downward pressure after a disappointing US jobs report and ISM survey last week, pointing to a more subdued recovery in the US, which postponed market expectations of the first rate hikes by the Fed. JPY also benefited from risk-off trades as investors piled funds into safe-haven currencies on slowing growth concerns. Local politics and a downside surprise to revised Q1 GDP helped to lift the pair back marginally above 80 by the end of the week.

Unlike in March when sharp appreciation in JPY post-earthquake ran into coordinated G7 intervention, Japanese officials and the IMF tipped intervention at this level was not imminent,. According to Finance Minister Yoshihiko Noda, the situation this time was perceived as "not of the yen's unequal strength but the dollar weakness. I think the market was affected by (investors') perceptions toward the U.S. economy, but in any case, I will closely watch developments in the market," Finance Minister Yoshihiko Noda said earlier this week. While USDJPY is down to 80, dollar weakness means that JPY nominal effective exchange rate is still at 200 day moving average, or 3.4% below pre-March intervention spike. As a result, a lower USDJPY is necessary before the BoJ or G7 would step in.

KRW Sees Support from Central Bank Rate Hikes

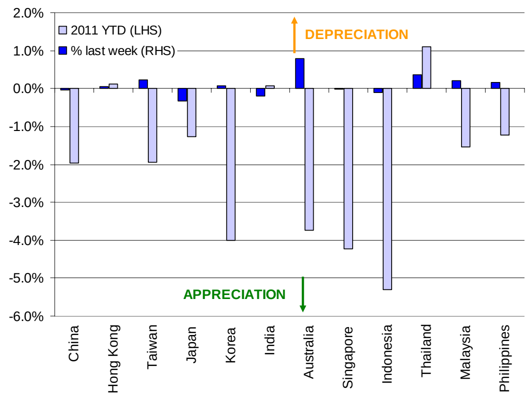
The Bank of Korea (BoK) raised its benchmark policy rate by 25 bps to 3.25%, the second time since February this year. The decision came as a mild surprise to the market, with KRW strengthening modestly after the announcement. The move was in line with our expectations, and it reflects the long-standing need to normalize rates to tackle inflation. While headline inflation has eased slightly in May, it was still well above BoK's target of 2.0-4.0%, with core inflation creeping up towards the upper end of the target band (see Highlights). In addition, the labor market remains tight despite some tentative signs of activity moderation recently, with wage dynamics threatening the inflation outlook going forward. Hence, we think it is appropriate for the BoK to take timely measures to anchor inflation expectations. We think the BoK will hike rates by another 50-75 bps for the remainder of the year, and see further scope for KRW to strengthen vs. the USD on the back of widening rate spreads and sustained capital inflows.

Chart 3
Stock markets



Source: BBVA Research and Bloomberg

Chart 4
Foreign exchange markets



Source: BBVA Research and Bloomberg

Economic Analysis

Highlights

Chinese authorities seeking a solution to local government debts

The People's Bank of China (PBoC) released their annual Regional Financial Situation Report last week, in which they updated their estimate of the level of outstanding loans to local government financing vehicles (LGFVs) as "less than 30% of outstanding RMB loans [of the banking system]". By our estimates, this would imply outstanding LGFV loans of around RMB 14.4 trillion, equivalent to 36% of GDP. Importantly, the PBoC estimate is higher than November figures issued by the supervisory authority (CBRC) of around RMB 10 trillion. (The difference may be due to classification issues.) Whatever the precise figure, LGFV loans are an important source of vulnerability to the financial system and debt burden of local governments, as around one-fifth of them are substandard (*China banking watch*). Indeed, this has been one of the key sources of risk facing China's economic outlook. In a sign of the authorities' awareness of these risks, and desire to head them off at an early stage, the Ministry of Finance was reported last week to have proposed a clean-up of LGFV obligations (details have not been officially announced, as the proposal was discussed in an internal meeting). According to press reports, the proposal would reduce LGFV loans by between RMB 2-3 trillion (the amount of substandard loans) through a combination of central government funds and write-offs by state-owned banks (generally thought to apply to the four largest banks). Apparently, any final solution would need to incorporate the views of other relevant governmental agencies including PBoC and CBRC. If the proposal were to survive in its current form, it could well lead to higher capital needs of listed banks, which have relatively high exposures to LGFVs.

Core inflation continues to rise, even has headline inflation eases

This past week was marked by further regional inflation releases and central bank policy meetings. In particular, headline inflation is showing signs of easing in a number of countries due to moderating commodity prices. On the policy front, Australia and Indonesia both held interest rates unchanged this past week, as expected; while Korea raised rates, in line with our expectations, but contrary to the consensus, which had expected no change. As noted in our recent publications (see Asia Outlook), inflation has emerged as the major policy concern across Asia in recent months. Encouragingly, supply side pressures have eased, with due to a moderation in commodity prices, in part because of slowing regional and global growth trends in Q2. For example, inflation in Korea and Indonesia moderated to 4.1% y/y and 6.0% y/y in May, below the levels of previous months. However, inflation remains above target ranges, and most importantly, core inflation in virtually all countries continues to rise (Chart 1), reflecting demand side pressures. In this regard, we expect further monetary tightening during the reminder of this year, despite the easing of headline inflation. That said, the pace of interest rate hikes is likely to remain gradual on concerns about slowing global growth.

China's May trade data supports a soft landing scenario, with important activity data awaited next week

China's May export growth eased to 19.4% y/y (BBVA: 20.0% y/y; consensus: 20.4% y/y), broadly in line with expectations and down from 29.9% y/y in April. By product category, most of the major exports declined due to weakening external demand. Meanwhile, imports for May registered a higher-than-expected growth of 28.4% y/y (BBVA: 24.8% y/y; consensus: 22.0% y/y), signaling continued robust domestic demand, which should help allay concerns of a hard landing. As a result, the trade surplus in May rose to USD 13.1 billion (BBVA: USD 18.1 billion, consensus: USD 19.3 billion) from USD 11.4 billion in April. Through the first 5 months of the year, the trade surplus amounts to a relatively modest US$ 23.0 billion. We expect the trade surplus to amount to US$ 140.0 billion for the full year, a decline from last year's US$ 183.1 billion, but still large enough to keep pressure on the authorities to allow currency appreciation. An important batch of monthly indicators will be released next week (June 14), including inflation, industrial production, retail sales, fixed asset investment, new loans and money supply growth. We expect inflation to pick up (see Weekly Indicator) toward a peak in June, and for the other activity indicators to register continued strong growth.

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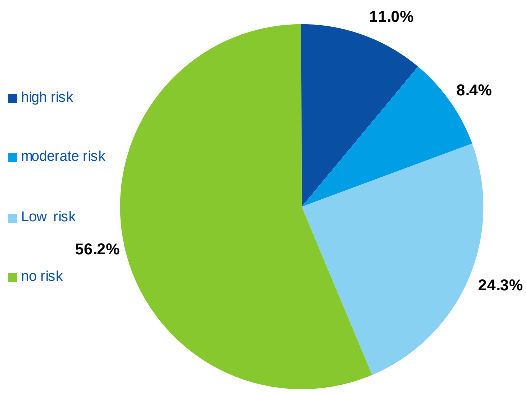
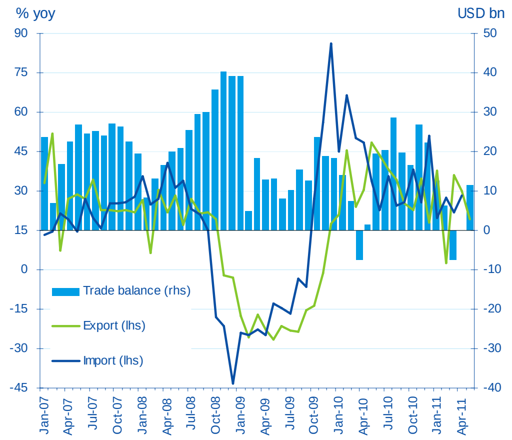
Chart 5
About a fifth of China's LGFV debt is believed to be at high or moderate risk



Source: BBVA Research and Bloomberg

Chart 6
China's trade surplus has been moderating so far this year, as import growth stays strong



Source: BBVA Research and Bloomberg

Calendar Indicators

China	Date	Period	Prior	Cons.
Actual FDI (YoY)	10-15 JUN	MAY	15.20%	- -
New Yuan Loans	11-15 JUN	MAY	739.6B	650.0B
Money Supply - M2 (YoY)	11-15 JUN	MAY	15.30%	15.50%
China Manpower Survey	14-Jun	3Q	29%	- -
Producer Price Index (YoY)	14-Jun	MAY	6.80%	6.50%
Consumer Price Index (YoY)	14-Jun	MAY	5.30%	5.50%
Retail Sales (YoY)	14-Jun	MAY	17.10%	17.00%
Industrial Production (YoY)	14-Jun	MAY	13.40%	13.10%
Hong Kong	**Date**	**Period**	**Prior**	**Cons.**
Industrial Production (YoY)	13-Jun	1Q	5.70%	- -
Producer Price (YoY)	13-Jun	1Q	7.60%	- -
Unemployment Rate SA	16-Jun	MAY	3.50%	- -
India	**Date**	**Period**	**Prior**	**Cons.**
Monthly Wholesale Prices YoY%	14-Jun	MAY	8.66%	8.89%
Japan	**Date**	**Period**	**Prior**	**Cons.**
Machine Orders YOY%	13-Jun	APR	6.80%	5.00%
Philippines	**Date**	**Period**	**Prior**	**Cons.**
Overseas Remittances (YoY)	15-Jun	APR	4.10%	- -
Singapore	**Date**	**Period**	**Prior**	**Cons.**
Retail Sales Ex Auto	15-Jun	APR	7.00%	- -
Retail Sales (YoY)	15-Jun	APR	0.80%	2.30%
Electronic Exports (YoY)	17-Jun	MAY	-10.40%	-18.10%
Non-oil Domestic Exports (YoY)	17-Jun	MAY	-1.80%	5.70%
Korea	**Date**	**Period**	**Prior**	**Cons.**
Export Price Index (YoY)	15-Jun	MAY	7.70%	- -
Import Price Index (YoY)	15-Jun	MAY	19.00%	- -

Indicator of the Week: China CPI for May (June 14)

Forecast: 5.6% y/y	Consensus: 5.5% y/y	Prior: 5.3% y/y

Comment: Headline inflation in May will likely climb further as food prices, which had showed signs of easing in recent months, are once again accelerating due to an ongoing drought in southeast China. Non-food components are continuing to rise as well. We expect inflation to peak in June, before declining to 4.0% y/y by the end of the year as commodity prices ease and as ongoing monetary tightening measures take effect. Market impact: A lower-than-expected reading could bolster market sentiment, which has been weak due to expectations of further tightening and slowing growth, while a higher-than-expected reading would do the opposite.

Calendar Events

	Current	Expected
Japan – BOJ Target Rate, June 14		
We expect no change in the interest rates	0.10%	0.10%
Philippines – Overnight Borrowing Rate, June 16	Current	Expected
We expect no change in the interest rates	4.50%	4.50%
India – Repo Rate, June 16	Current	Expected
We expect a hike of 25 bp in the Repo Rate	7.25%	7.50%

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STOCK MARKETS

INDEX	Last price	% change over a week	Year to date	% Change over 1 Y
China – Shanghai Comp.	2691.1	-1.4	-4.2	5.0
Hong Kong – Hang Seng	22441.8	-2.2	-2.6	14.3
Taiwan – Weighted	8915.5	-1.4	-0.6	24.1
Japan – Nikkei 225	9585.6	1.0	-6.3	0.4
Korea – Kospi	2064.4	-2.3	0.7	25.0
India – Sensex 30	18384.9	0.0	-10.4	8.6
Australia – SPX/ASX 200	4567.2	-0.3	-3.8	3.0
Singapore – Strait Times	3096.4	-1.6	-2.9	11.4
Indonesia – Jakarta Comp	3809.7	-0.9	2.9	37.5
Thailand – SET	1016.9	-3.9	-1.5	32.4
Malaysia – KLCI	1556.5	-0.2	2.5	20.5
Philippines – Manila Comp.	4232.4	-1.5	0.7	31.3

Last update: Friday, 11.15 Hong Kong time.

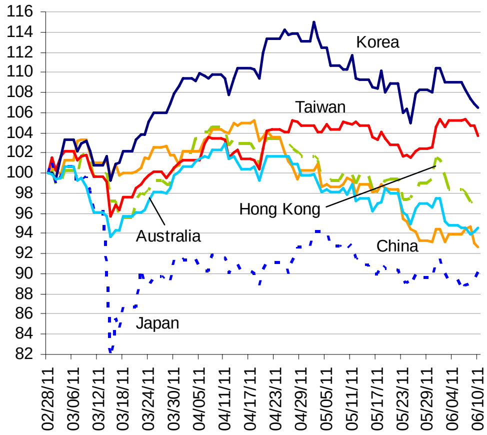
FOREIGN EXCHANGE MARKETS

CURRENCY	Spot	% change over a week	Forward 3-month	Forward 12-month
China (CNY/USD)	6.48	0.03	6.47	6.39
Hong Kong (HKD/USD)	7.78	-0.06	7.8	8
Taiwan (TWD/USD)	28.7	-0.23	28.60	28.05
Japan (JPY/USD)	80.1	0.31	80.1	79.8
Korea (KRW/USD)	1081	-0.05	1086.90	1102.05
India (INR/USD)	44.7	0.21	45.2	47
Australia (USD/AUD)	1.06	-0.74	1	n.a.
Singapore (SGD/USD)	1.23	0.04	1.23	1.2
Indonesia (IDR/USD)	8519	0.11	8583	8867
Thailand (THB/USD)	30.4	-0.36	30.58	31.0
Malaysia (MYR/USD)	3.01	-0.16	3.0	3
Philippines (PHP/USD)	43.3	-0.14	43.34	43.50

Last update: Friday, 11.15 Hong Kong time.

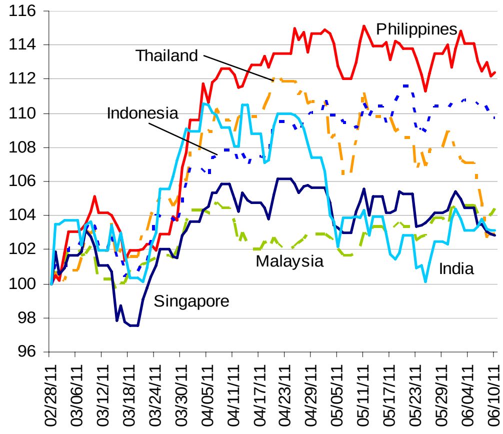
Charts

Chart 6
Stock Markets



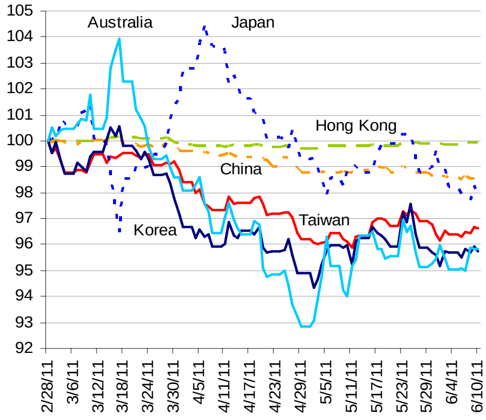
Source: BBVA Research and Bloomberg

Chart 7
Stock Markets



Source: BBVA Research and Bloomberg

Chart 8
Foreign Exchange Markets



Source: BBVA Research and Bloomberg

Chart 9
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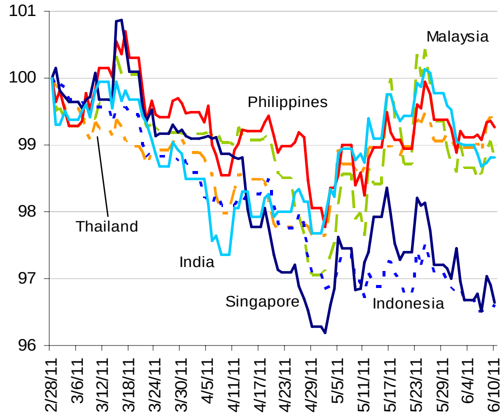
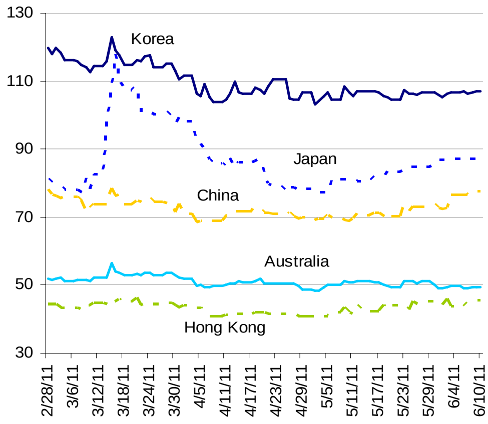


Source: BBVA Research and Bloomberg

Chart 10
Credit Default Swaps



Source: BBVA Research and Bloomberg

Chart 11
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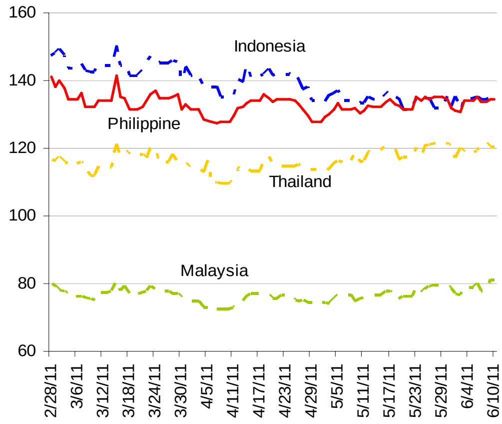

Source: BBVA Research and Bloomberg

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