

# Weekly Watch

## Asia

26 August 2011  
Economic Analysis

### Asia

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### Markets

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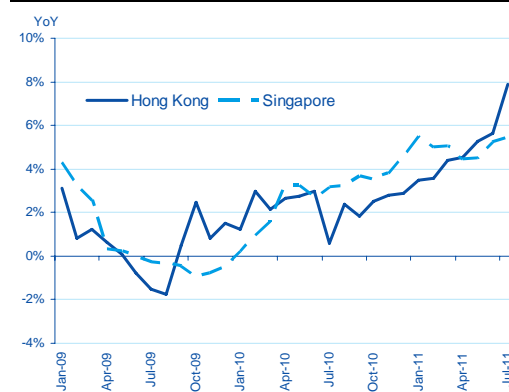
## Activity slows as inflation rages on

Markets across the region are no longer in free-fall, as risk aversion eases and investors await the Fed Chairman's speech at Jackson Hole (see Markets). While financial markets continue to take their cues from overseas, we remain optimistic that Asian growth will resume as momentum in China continues to propel regional demand. A downgrade of Japan's sovereign credit rating this week by Moody's has been largely shrugged off, as it was anticipated and reflects catch up with S&P and Fitch, although the political outlook is uncertain following the resignation of Prime Minister Kan. Activity indicators are showing further signs of a slowdown, in some cases below expectations (see below), although domestic demand remains resilient. At the same time, however, inflation outturns are above expectations, posing a dilemma for central banks as downside risks to growth increase.

### A big data week coming up

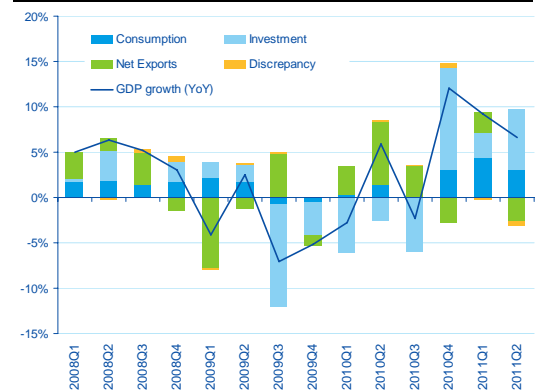
A few important data releases came out this week, including second quarter GDP in Thailand (see Highlights), inflation in Singapore (5.4% y/y; consensus: 5.0%), Hong Kong (7.9% y/y; consensus: 8.2%) (Chart 1), and Vietnam (23.0% y/y, prior: 22.2%), and industrial production in Taiwan (3.9% y/y; consensus: 5.4%), and Singapore (7.4% y/y; consensus: 7.8%). For the most part, the trends we have seen in recent months remain intact, namely slowing growth with rising inflation (especially in Vietnam where macro stability remains at risk). Much more important data will be released next week. In particular, markets will be watching China's PMI (see Weekly Indicator), activity indicators in Japan, GDP in India and the Philippines, and August inflation in Korea and Thailand. We expect activity indicators to show resilience, especially in China where we forecast an upturn in the August PMI, and in Japan where the post-earthquake recovery continues.

Chart 1  
Inflation rises in Hong Kong and Singapore



Source: CEIC and BBVA Research

Chart 2  
Thai's 2Q GDP slows on Japan supply disruptions



Source: CEIC and BBVA Research

Markets →

Highlights →

Calendar →

Markets Data →

Charts →

## Highlights

### China unveils measures to support Hong Kong's role as a financial center

The measures are in line with the gradual opening of China's capital markets

### Hong Kong: smooth sailing for now, with some challenges ahead

Slowing growth is helping to alleviate overheating pressures, but inflation remains high

### Thailand: slowing second quarter GDP

The newly elected government faces challenges in fulfilling promises and sustaining growth

## Economic Analysis

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## Markets

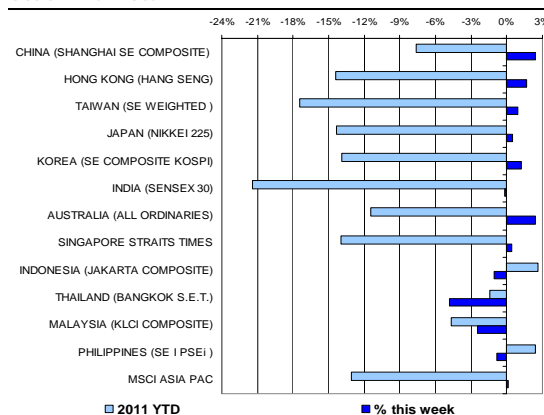
Equity markets are up slightly from last week, but market participants are continuing to lower expectations for global growth as they await Friday's Jackson Hole speech by the Federal Reserve Chairman. Fears of a potentially severe slowdown may be somewhat premature, after better-than-expected PMI outturns for August in Europe (51.1) and China (Flash HSBC PMI 49.8). Asian FX finished the week mixed as investors wait for more clarity on the macro environment.

## Moody's downgrades Japan

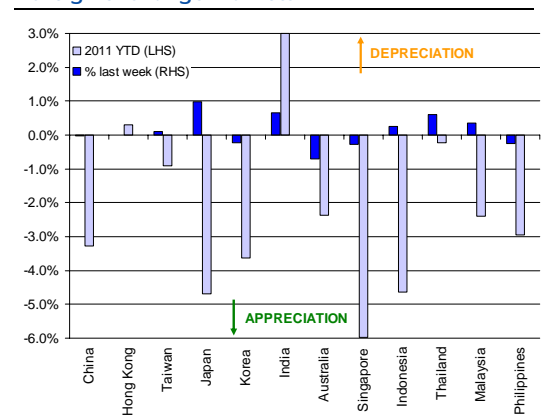
On Wednesday, Moody's downgraded Japan's sovereign rating from Aa2 to Aa3, placing Japan on the same level as China. Moody's decision was based on Japan's large budget deficits and elevated debt-to-GDP ratio, along with its challenging domestic outlook given weak economic growth and high post-earthquake reconstruction costs. The market response was muted as Moody's decision was not a surprise, and simply brought its rating in line with S&P and Fitch; nevertheless, the yen weakened towards the end of the week to 77.31, down 1% as expectations of the imminent resignation of Japan's Prime Minister mounted. The yen's strong level is placing pressure on Japanese exporters and poses a challenge, on top of the balancing act of trying to reduce the country's deficit against an economy that has contracted for three straight quarters. Already we have seen the government enacting new measures such as a US\$100 million credit facility designed to promote overseas purchases by Japanese companies, in an effort to support businesses harmed by the yen's strength.

## Singapore's conundrum

Inflation in Singapore rose to 5.4% yoy in July, which was both above the consensus (5.2%) and the Monetary Authority of Singapore's (MAS) target range of 4%-5%. The markets are considering the implications of this outturn in terms of how the Monetary Authority will respond in their next policy meeting, scheduled for October. The MAS conducts its monetary policy by adjusting the SGD NEER, and given inflation has remained elevated since 2010, it has been allowing the currency to appreciate. The SGD has strengthened 6.4% versus the dollar year-to-date to 1.20 SGD/USD, and has been Asia's best performing currency. Singapore is Asia Pacific's sole country that currently receives top ratings from Moody's, S&P and Fitch, and inflows to the region have been high as investors flock to higher-quality risk assets. Given concerns over global growth and Singapore's reliance on exports, the MAS will have to decide whether to allow the SGD to appreciate further. Our view is that given the openness of Singapore's economy and its susceptibility to a potential global slowdown, the MAS will turn its focus to growth over inflation. Therefore we think it is likely the MAS will adopt a wait-and-see approach in regards to further appreciation.

Chart 3  
Stock markets

Source: BBVA Research and Bloomberg

Chart 4  
Foreign exchange markets

Source: BBVA Research and Bloomberg

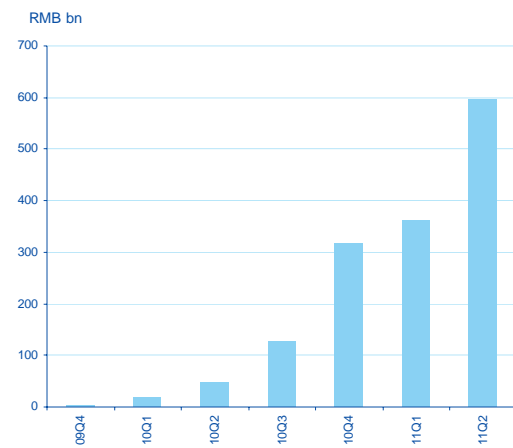
## Economic Analysis

## Highlights

**China unveils measures to support Hong Kong's role as a financial center**

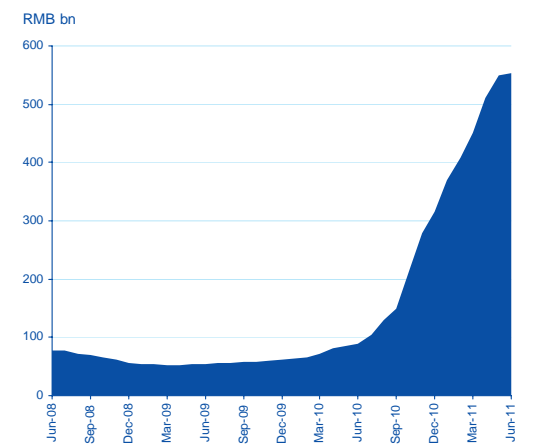
China's vice-premier Li Keqiang, the presumed successor to China's current Prime Minister Wen Jiabao, concluded a high-profile visit to Hong Kong last week with the unveiling of more than 30 separate measures to boost Hong Kong's economy and accelerate the internationalization of the RMB. The key elements included: (i) a promise to open China's domestic service sector to Hong Kong firms, within the existing framework of the Closer Economic Partnership Arrangement (CEPA); (ii) implementation of a pilot "mini-QFII" scheme to allow Hong Kong firms to invest offshore RMB (up to RMB20bn as an initial overall quota) in China's domestic stock market; and (iii) allowing mainland investors to purchase Hong Kong equities via an exchange-traded fund (ETF) listed in Shenzhen or Shanghai, expected to be in place by the end of this year. Details such as the precise timing and coverage of these proposals have yet to be announced. Taken together, the new proposals are expected to facilitate Hong Kong's economic integration with China and strengthen Hong Kong's role as the center of international asset management and offshore RMB business (Charts 5 and 6). Indeed, Hong Kong's stock market rose briefly on the announcement. Nevertheless, we do not expect the proposals to be implemented with a "big bang", given the Chinese authorities' preference for gradualism, meaning that near term benefits to Hong Kong will be limited.

Chart 5  
**RMB transactions across the border rise...**



Source: CEIC and BBVA Research

Chart 6  
**... as RMB deposits continue to soar**



Source: BBVA Research and CEIC

**Hong Kong: smooth sailing for now, with some challenges ahead**

Recent activity and price indicators in Hong Kong point to slowing growth with rising inflation. However, these outturns so far are broadly in line with our expectations, and are consistent with our full-year GDP growth projection of 5.0% for 2011 and end-year inflation of 5.2%. Moreover, the slowdown so far has helped alleviate, but not yet eliminate, overheating pressures. Second quarter GDP (released on August 12) slowed to 5.1% y/y, a decline of -0.5% q/q seasonally adjusted, from 7.5% y/y in Q1. This outturn was in line with our expectations (BBVA: 5.0% y/y, -0.3% q/q) but was well below the consensus forecast. The Q2 slowdown reflected a weakening of net exports, which were adversely affected by supply disruptions in Japan as well as sluggish external demand; indeed, just-released July export growth, of 9.2% y/y, was below consensus (14.2% y/y). On the other hand, domestic demand remained strong underpinned by steady consumption and investment. The unemployment rate for May remained at 3.4%, well below recent historical averages, indicating still-tight labor market conditions. Meanwhile, inflation accelerated further in July to 7.9% y/y from 5.6% y/y in June (Chart 7), but most of the jump reflected base effects (last year's price level in July was unusually low because of the government's public rental waiver that month). In asset markets, the stock market has recently slumped in line with global trends, while the property market has lost some of its momentum following previous tightening measures and global financial uncertainty. While our outlook for Hong Kong's growth remains positive in view of

Home →

Markets →

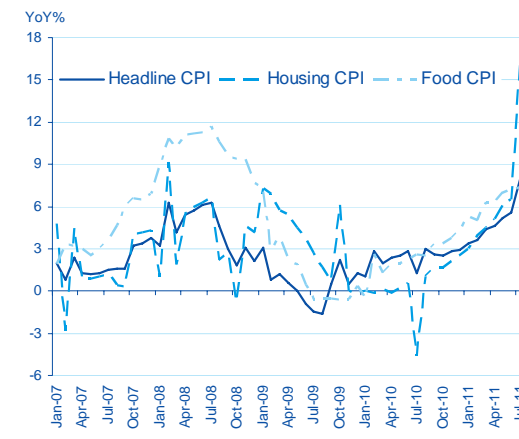
Calendar →

Markets Data →

Charts →

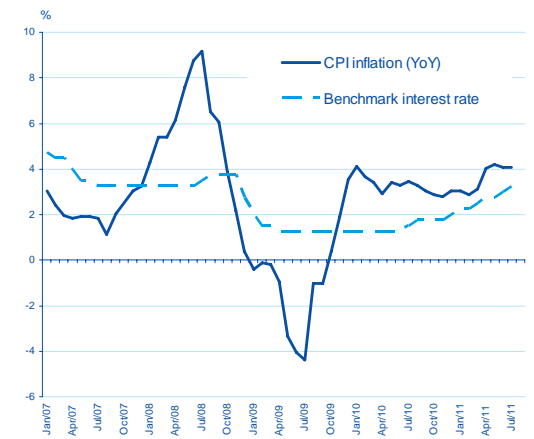
our expectations that global growth will remain on track, downside risks have increased. Given Hong Kong's openness, the economy remains vulnerable to a slowdown in external demand, and the authorities will need to stay vigilant to respond with supportive fiscal policies to support growth if needed.

Chart 7  
**Inflation rises in Hong Kong (due mostly to base effects)**



Source: CEIC and BBVA Research

Chart 8  
**The Bank of Thailand continues raising interest rates**



Source: CEIC and BBVA Research

### Thailand: slowing second quarter GDP adds to challenges

Thailand has officially joined the ranks of other slowing Asian economies, with second quarter GDP coming in at a slower-than-expected 2.6% y/y (consensus: 3.6%), from 3.0% y/y in the previous quarter (chart 2). Much of the slowdown was attributed to the impact of supply disruptions in Japan, given Thailand's heavy reliance on imported components, especially in the auto sector. Despite the slowdown and rising downside risks to the global environment, the Bank of Thailand this week moved to raise interest rates for a 7th consecutive time, to 3.5% (chart 8) as it seeks to contain core inflation to within the official target range of 0.5%-3.0% (current core inflation is 2.8% and headline is at 4.1%). We believe the BoT will stay on hold now through the rest of the year, and the authorities emphasized that the latest hike may mark the last for some time. We expect Thailand's economy to grow by 3.8% this year, after last year's strong growth of 7.8%. In the meantime, slowing growth could pose a challenge for the newly elected government of Yingluck Shinawatra. Shinawatra's populist pledges during her campaign could result in a sharp increase in the fiscal deficit. Such measures are likely to include an increase in the minimum wage, cuts in corporate taxes, and support programs to rice farmers. The latter may result in higher export rice prices, with regional implications for inflation given that Thailand is currently the world's largest rice exporter.

## Calendar Indicators

Australia	Date	Period	Prior	Cons.
Building Approvals (YoY)	30-Aug	JUL	-15.50%	--
Retail Sales s.a. (MoM)	1-Sep	JUL	-0.10%	--
China	Date	Period	Prior	Cons.
Industrial Profits YTD (YoY)	27-Aug	JUL	28.70%	--
PMI Manufacturing	1-Sep	AUG	50.7	51
HSBC Manufacturing PMI	1-Sep	AUG	49.3	--
Hong Kong	Date	Period	Prior	Cons.
Retail Sales - Value (YoY)	29-Aug	JUL	28.80%	--
India	Date	Period	Prior	Cons.
GDP (YoY)	30-Aug	2Q	7.80%	7.60%
Exports (YoY)	1-Sep	JUL	46.50%	--
Imports (YoY)	1-Sep	JUL	42.50%	--
Japan	Date	Period	Prior	Cons.
Overall Hhold Spending (YoY)	30-Aug	JUL	-4.20%	-4.00%
Jobless Rate	30-Aug	JUL	4.60%	4.60%
Retail Trade (YoY)	30-Aug	JUL	1.10%	0.10%
Industrial Production (MoM)	31-Aug	JUL P	3.80%	1.10%
Vehicle Production (YoY)	31-Aug	JUL	-13.90%	--
Housing Starts (YoY)	31-Aug	JUL	5.80%	4.60%
Vehicle Sales (YoY)	1-Sep	AUG	-27.60%	--
Philippines	Date	Period	Prior	Cons.
GDP (YoY)	31-Aug	2Q	4.90%	4.30%
GDP sa (QoQ)	31-Aug	2Q	1.90%	0.90%
Korea	Date	Period	Prior	Cons.
Industrial Production (MoM)	31-Aug	JUL	0.70%	1.00%
Industrial Production (YoY)	31-Aug	JUL	6.40%	6.30%
CPI Inflation (YoY)	1-Sep	AUG	4.70%	4.80%
Core CPI (YoY)	1-Sep	AUG	3.80%	--
Exports (YoY)	1-Sep	AUG	27.30%	24.50%
Imports (YoY)	1-Sep	AUG	24.80%	25.10%
Trade Balance	1-Sep	AUG	\$7223M	\$1740M
Thailand	Date	Period	Prior	Cons.
Exports (YoY)	31-Aug	JUL	16.40%	--
Imports (YoY)	31-Aug	JUL	23.50%	--
Trade Balance	31-Aug	JUL	\$1886M	--
CPI Inflation (YoY)	1-Sep	AUG	4.08%	--
Core CPI (YoY)	1-Sep	AUG	2.59%	--
Vietnam	Date	Period	Prior	Cons.
Retail Sales YTD (YoY)	24-31 AUG	AUG	22.30%	--
Industrial Production (YoY)	24-31 AUG	AUG	9.60%	--

Home →

Markets →

Highlights →

Markets Data →

Charts →

## Indicator of the Week: China PMI for August (September 1)

Forecast: 51.4

Consensus: 51.0

Prior: 50.7

Comment: China's Purchasing Managers' Index (PMI) for August will be next week's focus of attention for gauging China's underlying growth momentum amidst global financial turbulence and signs of weakening external demand. After four-months of consecutive declines, we expect the PMI to rebound, reflecting seasonal trends and a pickup in the HSBC flash PMI estimate (released last week). This would be consistent with our soft-landing scenario and 9.4% GDP projection for 2011. Market impact: a significantly weaker-than-expected reading could aggravate market concerns of a sharper slowdown, with negative implications for global growth, and increase expectations of looser macro policies in China and elsewhere.

## Markets Data

STOCK MARKETS	INDEX	Last price	% change over a week	Year to date	% Change over 1 Y
	China - Shanghai Comp.	2594.7	2.4	-7.6	-0.3
	Hong Kong - Hang Seng	19721.0	1.7	-14.4	-4.3
	Taiwan - Weighted	7409.1	0.9	-17.4	-3.6
	Japan - Nikkei 225	8759.1	0.5	-14.4	-1.7
	Korea - Kospi	1766.0	1.2	-13.9	2.1
	India - Sensex 30	16124.3	-0.1	-21.4	-11.5
	Australia - SPX/ASX 200	4201.8	2.4	-11.5	-3.5
	Singapore - Strait Times	2744.9	0.4	-14.0	-6.2
	Indonesia - Jakarta Comp	3802.7	-1.0	2.7	20.9
	Thailand - SET	1018.1	-4.8	-1.4	14.9
	Malaysia - KLCI	1447.5	-2.5	-4.7	2.8
	Philippines - Manila Comp.	4303.5	-0.8	2.4	19.7

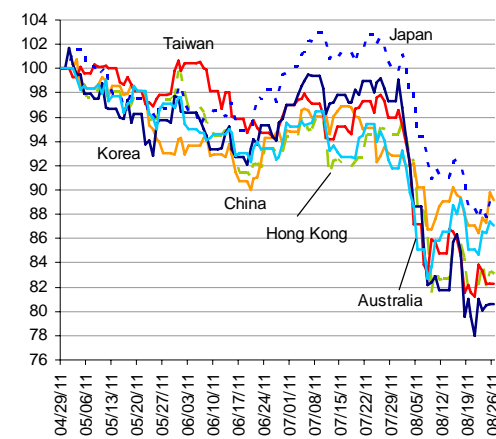
Last update: Friday, 11.15 Hong Kong time.

FOREIGN EXCHANGE MARKETS	CURRENCY	Spot	% change over a week	Forward 3-month	Forward 12-month
	China (CNY/USD)	6.39	0.02	6.37	6.29
	Hong Kong (HKD/USD)	7.80	0.01	7.8	8
	Taiwan (TWD/USD)	29.0	-0.11	28.84	28.35
	Japan (JPY/USD)	77.3	-0.98	77.2	76.8
	Korea (KRW/USD)	1085	0.23	1089.75	1094.95
	India (INR/USD)	46.1	-0.66	46.5	47
	Australia (USD/AUD)	1.05	0.71	1	n.a.
	Singapore (SGD/USD)	1.21	0.28	1.21	1.2
	Indonesia (IDR/USD)	8579	-0.24	8643	8885
	Thailand (THB/USD)	30.0	-0.60	30.17	30.6
	Malaysia (MYR/USD)	2.99	-0.35	3.0	3
	Philippines (PHP/USD)	42.5	0.25	42.43	42.46

Last update: Friday, 11.15 Hong Kong time.

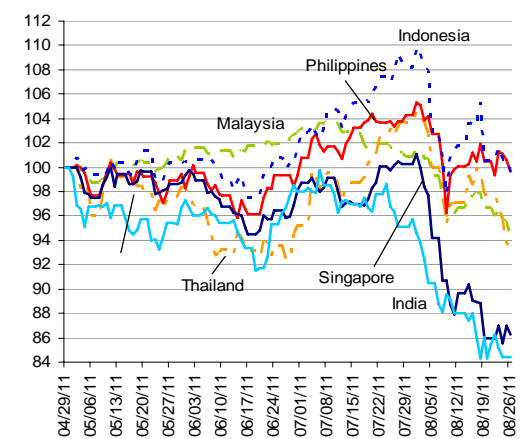
## Charts

Chart 9  
Stock Markets



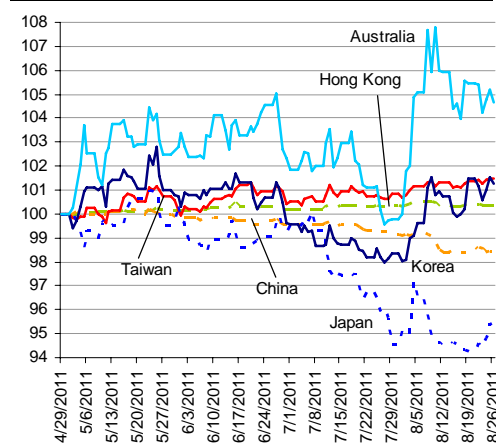
Source: BBVA Research and Bloomberg

Chart 10  
Stock Markets



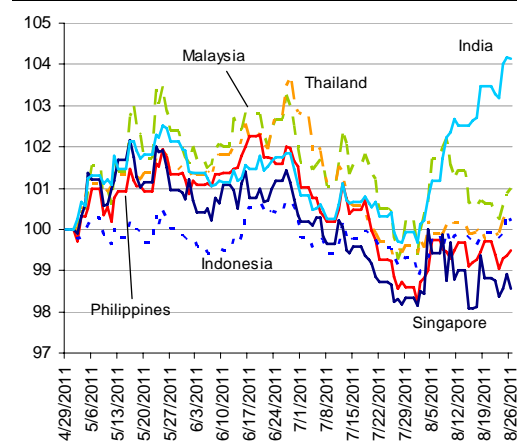
Source: BBVA Research and Bloomberg

Chart 11  
Foreign Exchange Markets



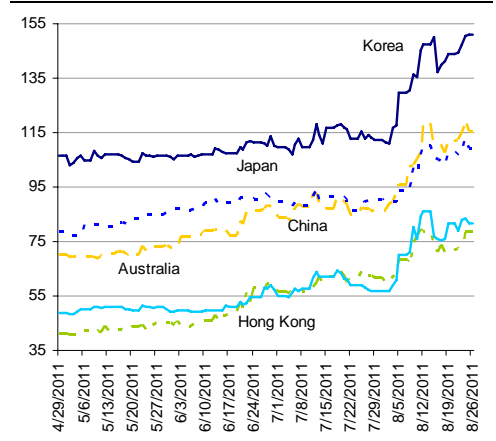
Source: BBVA Research and Bloomberg

Chart 12  
Foreign Exchange Markets



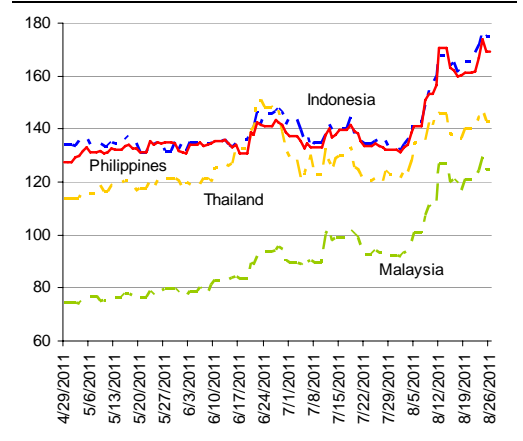
Source: BBVA Research and Bloomberg

Chart 13  
Credit Default Swaps



Source: BBVA Research and Bloomberg

Chart 14  
Credit Default Swaps



Source: BBVA Research and Bloomberg



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