

# Weekly Watch

## Asia

2 September 2011  
Economic Analysis

### Asia

**Stephen Schwartz**  
stephen.schwartz@bbva.com.hk

**Mario Nevares**  
mario.nevares@bbva.com.hk

**Fielding Chen**  
fielding.chen@bbva.com.hk

**Le Xia**  
xia.le@bbva.com.hk

**Zhigang Li**  
zhigang.li@bbva.com.hk

**Sumedh Deorukhkar**  
sumedh.deorukhkar@grupobbva.com

**Claire Chen**  
claire.chen@bbva.com.hk

**Jeffrey Cantwell**  
jeffrey.cantwell@bbva.com.hk

**Markets**  
**Richard Li**  
richard.li@bbva.com.hk

**Jeffrey Cantwell**  
jeffrey.cantwell@bbva.com.hk

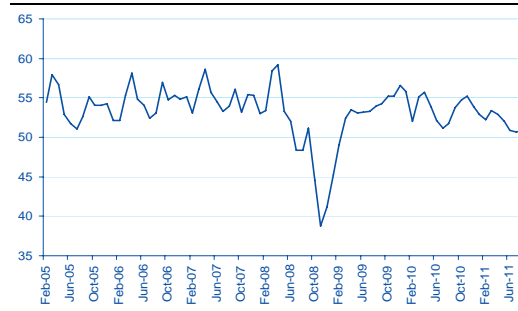
## Inflation poses a policy dilemma

With investor focus on global economic prospects and financial market turmoil, the region's rising inflation has seemingly passed into the background. Nevertheless, inflation persists, as seen in the most recent data releases, for example, in Thailand and Korea this week (see below). This poses a dilemma for central banks as external demand and growth slow. On the one hand, given rising inflation and a number of positive economic indicators – such as recent export outturns and China's latest PMI (Chart 1) – central banks should remain vigilant to keep inflationary expectations in check. On the other hand, signs of weakness are evident, particularly for export orders and industrial production. Thailand last week hiked rates once again, although it signaled that hikes may be reaching an end; and China last week broadened its reserve requirements, resulting in an effective tightening of liquidity conditions (see Highlights). A number of countries hold monetary policy meetings next week, in which we expect all to remain pat due to growth concerns; Korea faces a particular dilemma given the much higher-than-expected August inflation outturn, although even there, the authorities are likely to stay on hold for now due to global uncertainties.

### Slowing growth and higher inflation ahead of next week's monetary meetings

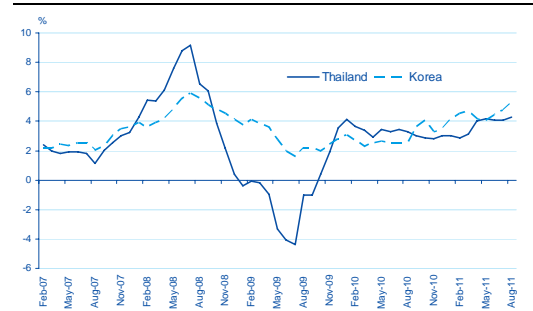
Second quarter GDP growth releases this past week in India (7.7% y/y; prior: 7.6%) and the Philippines (3.4% y/y; prior: 4.9%) added to the list of slowing Asian economies from weakening external demand. July industrial production outturns for Korea (3.8% y/y; consensus 6.2% y/y) and Japan (0.6% y/y; consensus: 1.4% y/y) both disappointed. On the inflation side, after a brief respite, Thailand (4.3% y/y; consensus: 4.0%) and Korea (5.3% y/y; consensus: 4.8%) both saw higher-than-expected outturns for August, but this was due mainly to higher food prices (Chart 1). In the coming week, central banks in Australia, Indonesia, Korea, Malaysia, Japan and the Philippines will hold policy meetings (see Calendar events), in which we expect all of them to stand pat. August inflation for will be released in China (see Weekly Indicator), Indonesia, Taiwan and the Philippines. Moreover, markets will keep a close eye on 2Q GDP for Australia.

Chart 1  
**China's PMI rebounds modestly**



Source: CEIC and BBVA Research

Chart 2  
**Inflation rises in Korea and Thailand**



Source: CEIC and BBVA Research

## Highlights

### China: broadening of reserve requirements amidst a robust PMI outturn

A pickup in August PMI reinforces expectations of a soft landing, while liquidity is tightened

### Japan's new Prime Minister faces the same old challenges

Japan's sixth Prime Minister in five years faces economic challenges and political uncertainty

### Korea struggles to contain inflation as its economy faces a slowdown

The BOK will face a dilemma next week as it copes with higher inflation and a slowing economy

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## Economic Analysis

Richard Li  
richard.li@bbva.com.hk

Jeffrey Cantwell  
jeffrey.cantwell@bbva.com.hk

## Markets

Financial markets have been reacting positively to the dovish Fed minutes, although investors are turning more cautious with equity markets down sharply today following disappointing euro-zone and regional PMI prints, and also ahead of the US non-farm payrolls report due out later today. For the week as a whole, however, Asian equities rallied, led by Vietnam, as the country's State Securities Commission continues to modernize its markets, this time by relaxing restrictions on margin account trading. China was the only exception, with losses for the week (Chart 3), as the latest adjustments to banks' required reserve ratios (see Highlights) rekindled fears of further tightening measures. Improving global risk sentiment has benefited Asian FX, with the AUD and KRW seeing the largest gains. Investors will put last month's market selloff behind them, but as long as the European outlook remains so weak, this rally may be touch-and-go in nature.

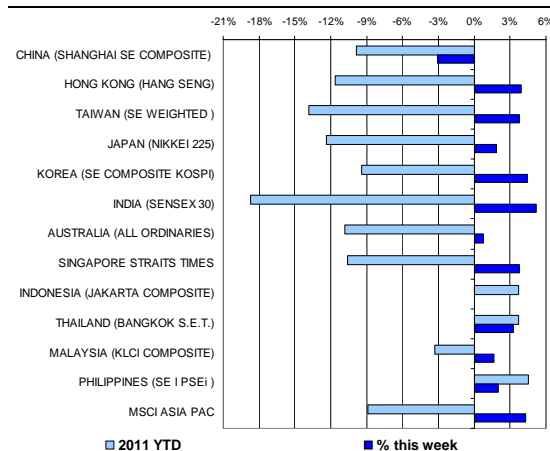
## Asian FX trend upwards in a lukewarm global growth environment

Although mixed, recent global indicators continue to point towards a soft-patch in the US and Europe. But for now there are still no imminent signs of an acute slowdown. We continue to pay close attention to China, as the country's ability to undergo a soft-landing would help cushion the rest of Asia from other macro headwinds. We currently expect Asian FX to appreciate against the USD for two reasons: first, even if US and European demand for Asian exports declines, Asian economies should find regional support as trade channels remain strong, which would help support growth. Second, expectations are for the Fed to continue to hold rates near zero, while Asian central banks will most likely need to maintain a tightening bias as growth continues and inflation stays elevated. Therefore, in this environment Asian FX will continue to benefit from the yield advantages stemming from this policy mismatch. The emphasis on rate spreads as an FX driver could become even more pronounced when and if global risk sentiment improves.

## Asian credit attracts a bid

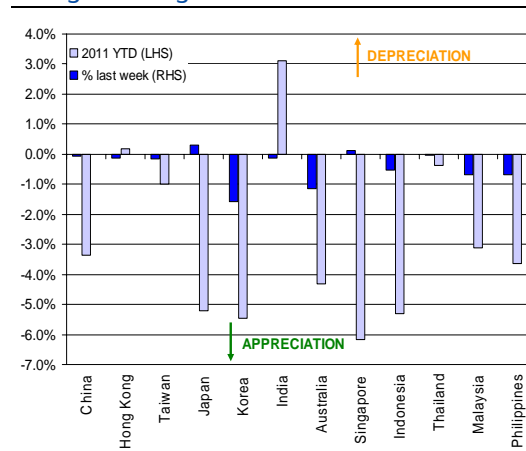
Credit markets are rallying across both investment grade and high-yield, with some of the major high-yielding names (Bumi, Berau, Evergrande) gaining 2%-3% for the week. Asian sovereign CDS spreads are lower, with Australia a noteworthy performer. Australia, along with Singapore, is quickly becoming a de-facto safe haven for risk assets. Australia's sovereign bonds have returned 9.5% this year, which is the best among 21 developed nations tracked by Bloomberg. We are seeing reasons for cautious optimism emanating from the data, as Asian economies are relatively well positioned to deal with a global downturn, especially given their scope for policy manoeuvre on both the monetary and fiscal policy fronts.

Chart 3  
Stock markets



Source: BBVA Research and Bloomberg

Chart 4  
Foreign exchange markets



Source: BBVA Research and Bloomberg

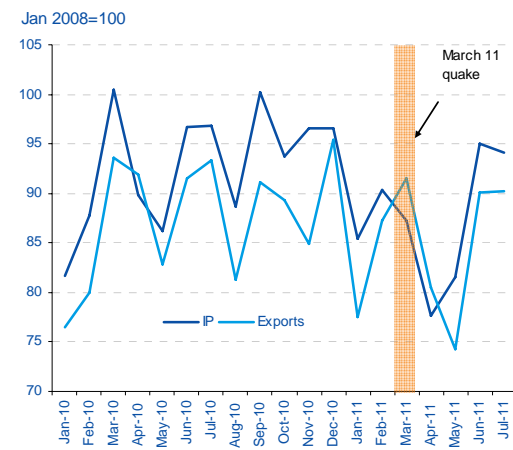
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## Highlights

**China: broadening of reserve requirements amidst a robust PMI outturn**

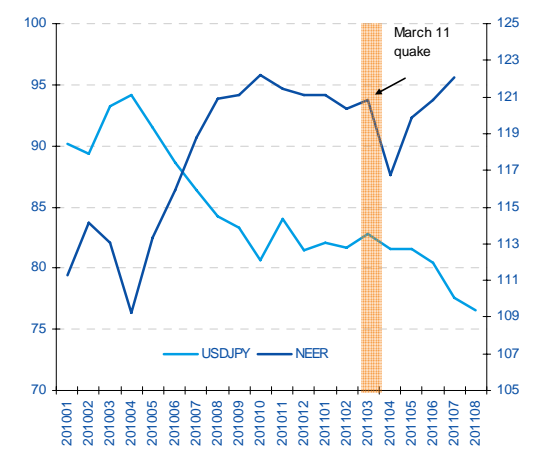
Against a backdrop of growing downside risks to the global economy, the latest (August) reading of the Manufacturing Purchasing Managers Index (PMI) shows that China's economy remains resilient. In particular, the PMI ticked up for the first time in four months, to 50.9% from 50.7% in July, within the 50+ expansion zone. The rebound reflects steady industrial production and robust domestic demand. While the outturn was slightly below expectations (Consensus: 51.0%; BBVA: 51.4%), and new export orders fell due to weakening external demand, it should nevertheless help bolster confidence in China's growth momentum. Separately, early this week the authorities were reported to have broadened the base for calculating banks' required reserve ratios, amounting to an effective tightening of 100-130 bps in the RRR. The specific move, to be phased in over six months, is to include banks' margin deposits in the calculation, which has been interpreted by the market as an effort by the authorities to clamp down on credit extended through bankers' acceptances and other such loopholes. It came as somewhat of a surprise as many observers had not expected further monetary tightening measures given the rise in global uncertainties. However, with activity indicators pointing to robust growth momentum and inflation having reached a high of 6.5% in July, the move may be understandable, and in line with our previous expectations of another hike in the RRR and one more interest rate hike.

Chart 5

**Japan's IP and exports have recovered to near pre-quake levels**

Source: BBVA Research and Bloomberg

Chart 6

**Japanese yen has strengthened**

Source: BBVA Research and Bloomberg

**Japan's new Prime Minister faces the same old challenges**

Yoshihiko Noda became Japan's new Prime Minister this past week, the sixth change of post over in the last five years. He replaces Naoto Kan, and previously served as Finance Minister in Kan's Administration. The new Cabinet was announced today, emphasizing party unity and consultation with opposition parties. Noda is known as a fiscal conservative, advocating increases in consumption and income taxes to fund the nation's social welfare costs and post-quake reconstruction spending. Frequent changes in Japan's leadership have underscored a climate of political instability and government weakness, at a time when decisive actions are needed to spur lagging growth, address the high public debt (over 200% of GDP), and implement post-quake reconstruction activities. Moody's ratings agency, citing the frequent changes in administration, lowered Japan's sovereign credit rating on August 24 to Aa3, playing catch-up to previous moves by S&P and Fitch. A political consensus for Noda's efforts to implement tax hikes has yet to be reached, ahead of a third supplementary budget to be submitted to Parliament later this month. Another challenge to the new cabinet is the strong Japanese yen, which has appreciated sharply given the currency's safe haven characteristics (Charts 6), thereby undermining exports, which are a key driver of Japan's growth. To soften the impact of the rising yen, the government recently announced a one-year subsidized loan program (USD 100 billion) to help domestic companies,

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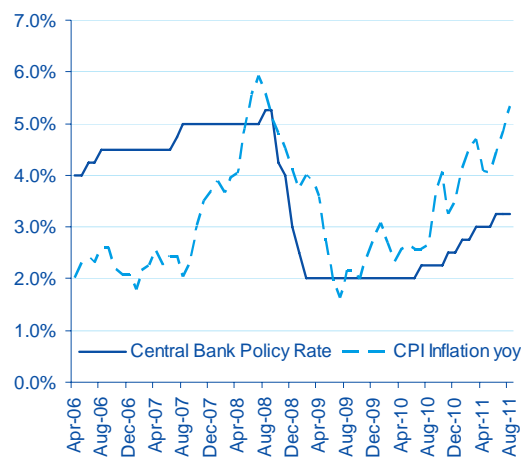
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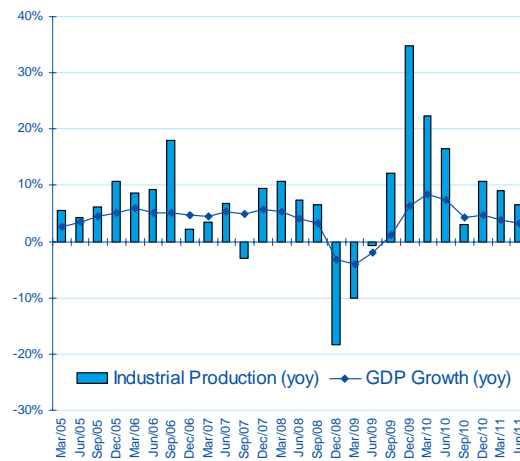
following recent efforts at currency intervention in early August. Meanwhile, on the positive side, the economy is continuing to recover from disruptions following the earthquake and tsunami, reaffirmed by the July's industrial production data (-2.6% y/y) released in the past week (Chart 5). We expect a further rebound during the remainder of the year, on the restoration of supply chains as well as the post-quake reconstruction spending, despite power shortages.

Chart 7  
**Will rising Korean inflation prompt more hikes?**



Source: CEIC and BBVA Research

Chart 8  
**The Korean economy shows signs of slowing**



Source: CEIC and BBVA Research

### Korea struggles to contain inflation as its economy faces a slowdown

The Bank of Korea (BOK) will face a difficult policy dilemma when it meets next Thursday for its monthly policy meeting. The BOK has hiked interest rates three times this year, most recently in June, to 3.25%, as it seeks to “normalize” rates from their exceptionally low levels of 2.0% during the global financial crisis. Meanwhile, inflation has continued to rise, reaching a much higher-than-expected 5.3% y/y in August (consensus: 4.8%), well above the official 2-4% inflation target (Chart 7). Rising inflation reflects higher food prices, but more importantly still strong underlying demand pressures (core inflation rose to 4.0% y/y in August). At the same time, however, the economy is showing signs of slowing. Having already reduced its GDP forecast for 2011 from 5% to 4.5% back in June (in line with our projection), on Monday Finance Minister Bahk Jae-wan hinted that the estimate may be revised downwards yet again as global uncertainties persist. Data released this past week for July show that industrial production fell to its lowest level in 10 months (3.8%), well short of consensus (6.2%), and while August exports were above expectations (27.1% vs consensus 25.0%), the export order subcomponent of Korea's PMI slowed, suggesting a downtrend in the period ahead. The outlook for exports, which account for half of the economy, remains all the more challenging as the domestic manufacturers confidence index currently lies at a 21-month low while in one of its key markets, the US, consumer confidence currently rests at a two-year low. That said, the central bank will need to remain vigilant in combating inflationary expectations. It will be a close call for the BoK this week, but on balance we think they stay on hold.

## Calendar Indicators

| Australia                    | Date  | Period | Prior | Cons.  |
|------------------------------|-------|--------|-------|--------|
| Gross Domestic Product (YoY) | 7-Sep | 2Q     | 1.0%  | 0.60%  |
| Unemployment Rate            | 8-Sep | AUG    | 5.1%  | 5.10%  |
| China                        | Date  | Period | Prior | Cons.  |
| China Non-manufacturing PMI  | 3-Sep | AUG    | 59.6  | --     |
| CPI Inflation (YoY)          | 9-Sep | AUG    | 6.5%  | 6.10%  |
| Industrial Production (YoY)  | 9-Sep | AUG    | 14.0% | 13.70% |
| Retail Sales (YoY)           | 9-Sep | AUG    | 17.2% | 16.90% |
| Indonesia                    | Date  | Period | Prior | Cons.  |
| CPI Inflation (YoY)          | 5-Sep | AUG    | 4.6%  | 4.70%  |
| Exports (YoY)                | 5-Sep | JUL    | 49.3% | 47.20% |
| Imports (YoY)                | 5-Sep | JUL    | 28.3% | 25.60% |
| Japan                        | Date  | Period | Prior | Cons.  |
| Machine Orders (MoM)         | 8-Sep | JUL    | 7.7%  | -4.00% |
| GDP Annualized               | 9-Sep | 2Q F   | -1.3% | --     |
| Malaysia                     | Date  | Period | Prior | Cons.  |
| Exports YoY%                 | 8-Sep | JUL    | 8.6%  | 7.70%  |
| Imports YoY%                 | 8-Sep | JUL    | 6.3%  | 6.20%  |
| Industrial Production YoY    | 9-Sep | JUL    | 1.0%  | 2.90%  |
| Philippines                  | Date  | Period | Prior | Cons.  |
| CPI Inflation (YoY)          | 6-Sep | AUG    | 5.1%  | 5.00%  |
| Korea                        | Date  | Period | Prior | Cons.  |
| GDP at Constant Price (YoY)  | 6-Sep | 2Q F   | 3.4%  | --     |
| Taiwan                       | Date  | Period | Prior | Cons.  |
| CPI Inflation (YoY)          | 5-Sep | AUG    | 1.3%  | 1.50%  |
| Exports (YoY)                | 8-Sep | AUG    | 17.6% | 14.70% |
| Imports (YoY)                | 8-Sep | AUG    | 14.0% | 13.80% |

### Indicator of the Week: China CPI inflation for August (September 9)

Forecast: 6.1% y/y

Consensus: 6.1% y/y

Prior: 6.5% y/y

Comment: We expect inflation to ease after having peaked in July, on moderating food prices and favorable base effects. That said, the August outturn is likely to remain well above the authorities' comfort level as inflation pressures persist, causing the PBoC to keep a close eye on liquidity. Looking forward, we expect inflation to fall further during the rest of the year, providing room for possible stimulus measures, if needed, in light of global uncertainties. Market impact: A higher-than-expected inflation outturn could reignite expectations of another rate hike, which have recently diminished due to slowing growth and heightened global uncertainties.

## Calendar Events

### Australia - RBA Cash Target, September 6

We expect no change in the target rate.

### Japan - BOJ Target Rate, September 7

We expect no change in the target rate.

### Indonesia - Bank Indonesia Reference Rate, September 8

We expect no change in the reference rate.

### Malaysia - Overnight Rate, September 8

We expect no change in the overnight rate.

### Philippines - Overnight Borrowing Rate, September 8

We expect no change in the overnight rate.

### Korea - BoK Monetary Policy Meeting, September 8

We expect no change in the repo rate.

| Current | Consensus |
|---------|-----------|
| 4.75%   | 4.75%     |

| Current | Consensus |
|---------|-----------|
| 0.10%   | 0.10%     |

| Current | Consensus |
|---------|-----------|
| 6.75%   | 6.75%     |

| Current | Consensus |
|---------|-----------|
| 3.00%   | 3.00%     |

| Current | Consensus |
|---------|-----------|
| 4.50%   | 4.50%     |

| Current | Consensus |
|---------|-----------|
| 3.25%   | 3.25%     |

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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.     | 2532.5     | -3.1                 | -9.8         | -4.6              |
|               | Hong Kong - Hang Seng      | 20365.2    | 4.0                  | -11.6        | -2.4              |
|               | Taiwan - Weighted          | 7726.7     | 3.8                  | -13.9        | 0.1               |
|               | Japan - Nikkei 225         | 8960.6     | 1.9                  | -12.4        | -1.1              |
|               | Korea - Kospi              | 1859.0     | 4.5                  | -9.4         | 4.7               |
|               | India - Sensex 30          | 16676.8    | 5.2                  | -18.7        | -7.2              |
|               | Australia - SPX/ASX 200    | 4232.2     | 0.8                  | -10.8        | -6.6              |
|               | Singapore - Strait Times   | 2851.8     | 3.8                  | -10.6        | -4.5              |
|               | Indonesia - Jakarta Comp   | 3841.7     | 0.0                  | 3.7          | 23.7              |
|               | Thailand - SET             | 1071.2     | 3.3                  | 3.7          | 16.4              |
|               | Malaysia - KLCI            | 1468.3     | 1.6                  | -3.3         | 1.9               |
|               | Philippines - Manila Comp. | 4391.8     | 2.0                  | 4.5          | 19.8              |

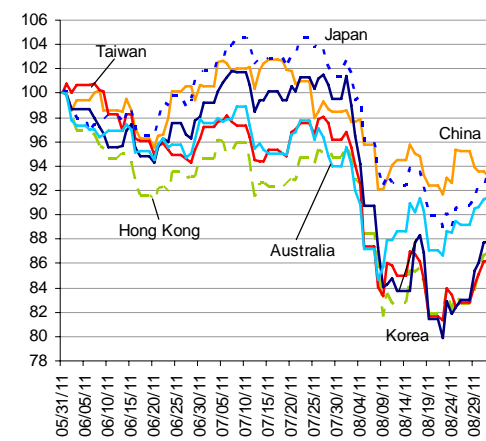
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| FOREIGN EXCHANGE MARKETS | CURRENCY              | Spot | % change over a week | Forward 3-month | Forward 12-month |
|--------------------------|-----------------------|------|----------------------|-----------------|------------------|
|                          | China (CNY/USD)       | 6.38 | 0.06                 | 6.35            | 6.28             |
|                          | Hong Kong (HKD/USD)   | 7.79 | 0.12                 | 7.8             | 8                |
|                          | Taiwan (TWD/USD)      | 29.0 | 0.17                 | 28.77           | 28.23            |
|                          | Japan (JPY/USD)       | 76.9 | -0.31                | 76.8            | 76.4             |
|                          | Korea (KRW/USD)       | 1065 | 1.62                 | 1070.40         | 1077.42          |
|                          | India (INR/USD)       | 46.1 | -1.00                | 46.4            | 47               |
|                          | Australia (USD/AUD)   | 1.07 | 1.16                 | 1               | n.a.             |
|                          | Singapore (SGD/USD)   | 1.20 | -0.11                | 1.20            | 1.2              |
|                          | Indonesia (IDR/USD)   | 8519 | 0.54                 | 8576            | 8805             |
|                          | Thailand (THB/USD)    | 30.0 | 0.00                 | 30.13           | 30.6             |
|                          | Malaysia (MYR/USD)    | 2.97 | 0.70                 | 3.0             | 3                |
|                          | Philippines (PHP/USD) | 42.2 | 0.69                 | 42.10           | 42.14            |

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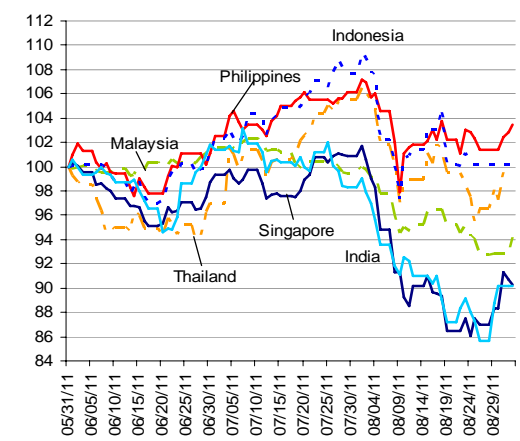
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Chart 9  
Stock Markets



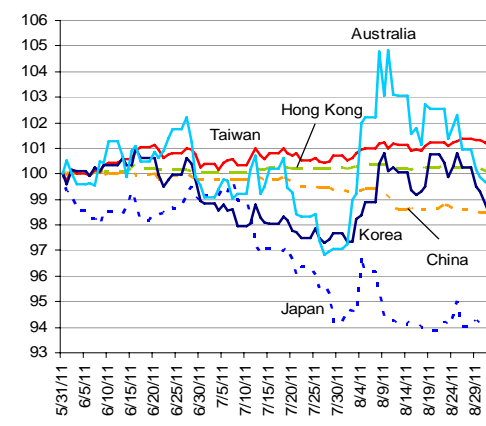
Source: BBVA Research and Bloomberg

Chart 10  
Stock Markets



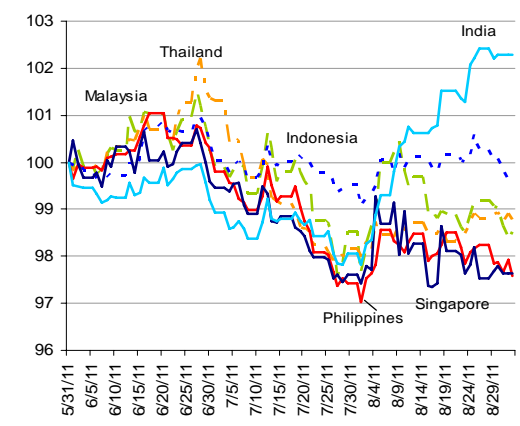
Source: BBVA Research and Bloomberg

Chart 11  
Foreign Exchange Markets



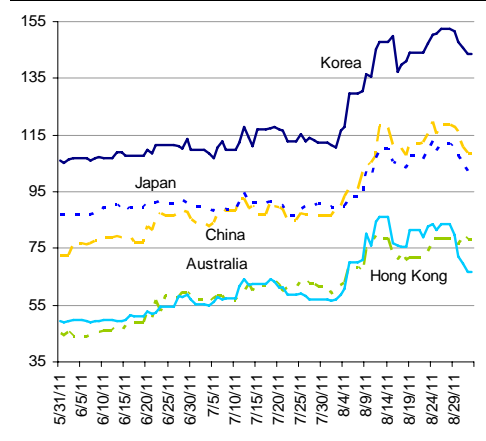
Source: BBVA Research and Bloomberg

Chart 12  
Foreign Exchange Markets



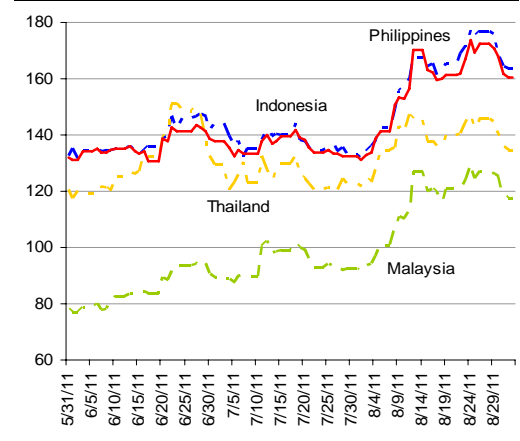
Source: BBVA Research and Bloomberg

Chart 13  
Credit Default Swaps



Source: BBVA Research and Bloomberg

Chart 14  
Credit Default Swaps



Source: BBVA Research and Bloomberg



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