Weekly Watch
Asia

23 September 2011
Economic Analysis

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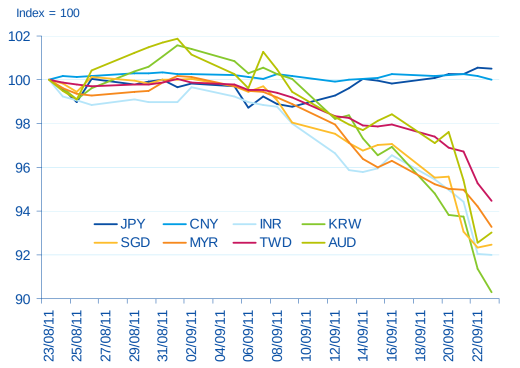
Asian markets tumble on global trends

Global economic jitters are causing a broad sell-off (see Markets). In particular, Europe's deepening debt and banking crises, along with concerns about the US growth outlook are leading to heightened risk aversion, with investors pulling out of risk assets across the region, as elsewhere in emerging markets. Regional currencies have been hard hit (Chart 1), reaching 10-month lows in some cases (the Japanese yen and Chinese CNY are exceptions, given the former's safe haven characteristics and the latter's heavy management). In addition, concerns are growing about the impact of worsening global conditions on Asia's growth outlook. We have marked down our regional growth projections (Highlights; see our revisions *here*), although only modestly at this stage given still-strong activity indicators and the region's strong fundamentals, which make it well placed to weather the fallout. Indeed, the declines in stock market indices across the region, as steep as they are, are so far less pronounced in Asia than in Latin America and Europe (Chart 2).

Upside inflation surprise in Singapore; weak trade in Japan and Taiwan

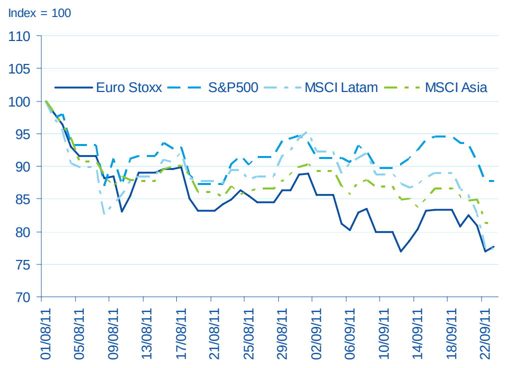
After a succession of rate hikes to dampen inflation, we expect most Asian central banks to stay on hold for the remainder of the year due to global uncertainties. Inflation has begun to ease in a number of economies, such as in Malaysia for a third consecutive month (3.3% y/y; prior: 3.4%) –, and Hong Kong due to base effects (5.7% y/y; prior: 7.8%). Both were broadly in line with expectations (chart 2). On the other hand, inflation in Singapore surprised to the upside rising to 5.7% (prior: 5.4% y/y; consensus: 5.2%) on higher food and rent costs. At the margin, this will make it harder for the Monetary Authority of Singapore to ease monetary policy (by slowing the pace of appreciation), as we expect, at their mid-October policy meeting. In a sign that slower global growth may be having an effect on exports, outturns in Japan (2.8% y/y; consensus: 8.0%) and for export orders in Taiwan (5.26% y/y; consensus: 6.95%) both came in below expectations. The coming week will see the release of China's PMI for September (see Weekly indicator), which will be watched especially closely following this past week's release of a disappointing flash Markit estimate; also on the calendar are industrial production in Japan, Korea, Singapore and Vietnam.

Chart 1
Regional currencies have depreciated sharply



Source: Bloomberg and BBVA Research

Chart 2
Equity markets decline



Source: Bloomberg and BBVA Research

Highlights

Update on China's RMB internationalization
RMB business is growing, but challenges to further internationalization remain

Downward global revisions spur modest changes to our Asia forecasts
Our downward revisions to 2011 and 2012 regional growth are modest so far

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Markets

Markets unimpressed by the Fed's latest moves

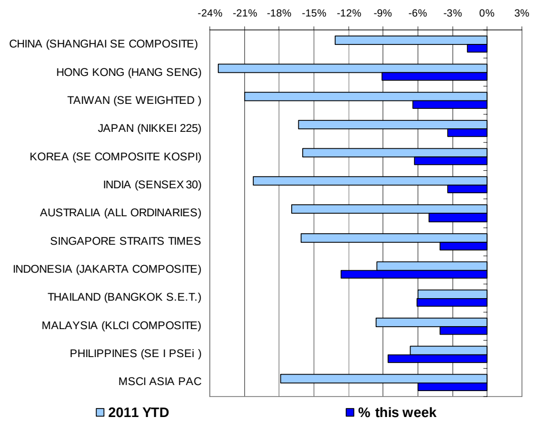
Global investors continue to focus on the risks of to the economic outlook, the European debt crisis and the capacity of policymakers to address these problems promptly. Earlier this week the FOMC announced after a two-day meeting its plans to increase the average duration of the Fed's bond portfolio in an "Operation Twist", by selling $400 bn 3Y-and-under securities and using the proceeds to purchase securities in the 6-30Y space. Markets appeared to have fully priced in the Fed's action before the meeting, but reacted negatively to the Committee's downbeat assessment of the economic outlook. Coupled with Moody's downgrade of three American banks, a soft reading for the HSBC flash estimate of China's Manufacturing PMI, continued uncertainties in the Greece-Troika negotiations and a disappointing Eurozone PMI outturn, risk aversion escalated. The dollar index climbed to a seven month high, commodity prices slumped to their lowest levels of the year, and 30-year US treasury yields plunged below 3% on global risk aversion. Equity markets slumped in Asia, with the Hang Seng dropping nearly 5% on Thursday alone. The MSCI Asia Pacific Index reached 113.52 on Thursday, its lowest close since July 7, 2010. Spreads were broadly wider across Asian sovereigns, high grade and high yield, as investors decide the risks outweigh the benefits in the markets, for the time being.

Asian currencies drop to a 10-month low

Asian currencies have fallen to new lows, with the benchmark index down by nearly 4.0% in less than two weeks. KRW has led the losses vs. the USD, falling 5.8%, followed by SGD (-4.5%) and INR (-4.7%). Central banks in the region such as Korea and Indonesia have been spotted intervening to smooth volatility. In retrospect, Asian currencies had initially been resilient to escalating risk aversion and an equities sell-off in August (a trend that was also seen in some other EM currencies), but started capitulating in September. Three related factors help explain this pattern in our view. First, both global growth and the European situation indicated few signs of improvement throughout the summer, and markets started to reduce expectations for year-end rallies in risky assets.; given Asian assets had generally outperformed on a regional basis, profit taking has been an obvious choice for global portfolio managers. Secondly, global FX investors piled into long USD positions as risk sentiment continued to worsen, notwithstanding US fiscal woes and possible additional (QE) easing from the Fed. The USD index has increased by 5.4% since September 1; the latest CFTC Report indicated markets were already net-long the USD. Finally, central banks in the region started to shift attention from inflation to growth and signal a more neutral stance. A flatter yield curve in the region has reduced the yield advantages of Asian currencies. Markets also perceive regional authorities as being in favor of weaker currencies should there be an environment of slowing demand and moderating inflation.

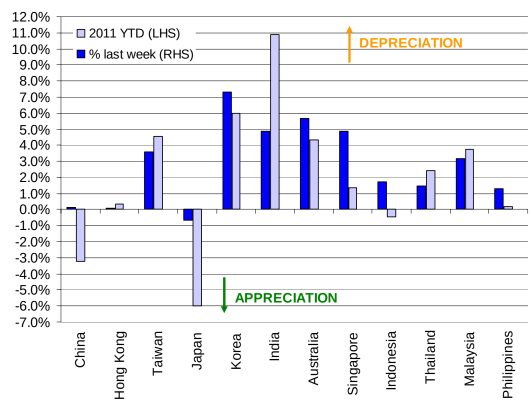
Our base-case is still that the developed countries should avoid sliding into recession and Europe can muddle through. Additionally, Asian economies have strong macro fundamentals in our view and most are well positioned in a low global growth situation.

Chart 3
Stock markets



Source: BBVA Research and Bloomberg

Chart 4
Foreign exchange markets



Source: BBVA Research and Bloomberg

Economic Analysis

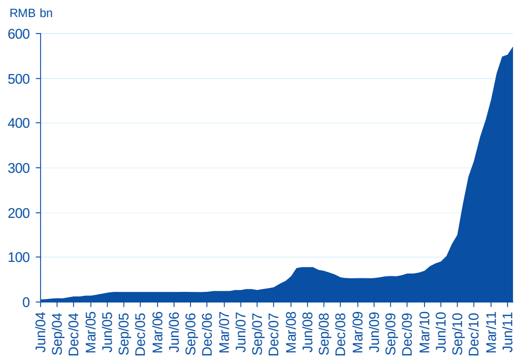
Highlights

Update on China's RMB internationalization

The internationalization of China's currency continues to generate interest among the international banking community for the business opportunities it poses. This is especially true for Hong Kong, which has emerged as the main financial center for RMB activity. According to the latest official statistics (of the Hong Kong Monetary Authority, HKMA), RMB deposit in Hong Kong have grown by 82% since the beginning of the year (from RMB315 to RMB572 billion at the end of July). Meanwhile, RMB trade settlement conducted through Hong Kong banks reached RMB800 billion in the first half of 2011, more than double the level recorded for all of last year (RMB370 billion), and accounting for around 85% of total RMB trade settlement with China globally. A further sign of the expanding business opportunities is the growth of offshore RMB bond market ("Dim Sum" market), with the outstanding volume having grown to RMB 178 billion in August from RMB 48 billion at the beginning of this year due to new issuance. As we have noted in previous Weeklies, the momentum of RMB internationalization was given a boost last month when the Chinese authorities announced a new set of measures to speed up the process. These measures, which are expected to become effective within this year, include: i) an expansion of the pilot program of cross-border trade settlement to cover all of China (from 20 provinces/municipalities previously); ii) permitting foreign direct investment (FDI) into China in RMB raised offshore; iii) introduction of a "mini-QFII (RQFII) program to allow investors to invest offshore RMB in China's domestic bond and stock markets (subject to a relatively small RMB 20 billion at first).

Chart 5

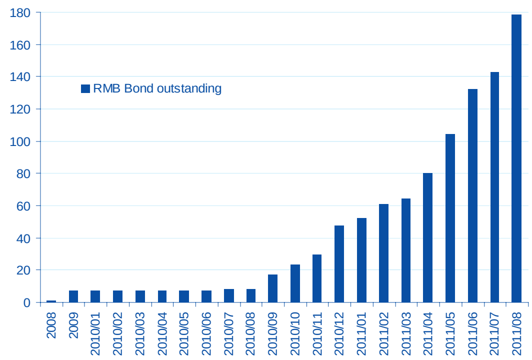
RMB deposits increase in Hong Kong...



Source: BBVA Research and Bloomberg

Chart 6

...and issuance of RMB bonds grows



Source: BBVA Research and Bloomberg

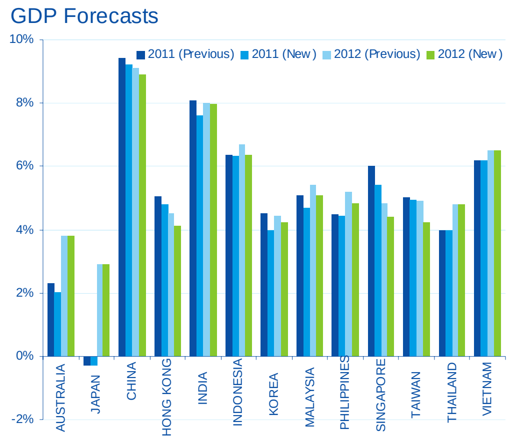
Despite the growth of RMB business and the most recent policy initiatives, a number of challenges remain. First, the majority of RMB settled trades are still lopsided, mainly consisting of Chinese importers using RMB rather than USD to settle their payments. Ironically, this has had the effect of speeding up official reserve accumulation, contrary to the intentions of the authorities when they introduced the program. Second, headwinds to the growth of the offshore RMB market remain due to the limited availability of investment channels. As such, the growth of RMB deposits may have more to do with expectations of currency appreciation than for economic use or investment. Accordingly, any shift in expectations toward a slowdown in the pace of appreciation could result in a slowing, or even reversal, of RMB deposits. Ultimately, a more complete internationalization of the currency will require full convertibility of the currency and an open capital account. Given the authorities' reluctance to open the capital account too fast, however, and their preference for a gradual approach, internationalization may take time. That said, recent signs suggest that the process might move faster than previously expected. For example, although there is still no official timetable, press reports of official comments have indicated that full capital account convertibility and exchange rate flexibility could occur as early as 2015.

Downward global revisions spur modest changes to our Asia forecasts

Our global economics team has revised down our US and European growth projections for 2011 and 2012 downward (to 1.6% and 2.3%, respectively for the US, and to 1.7% and 1.0% in Europe). The revisions are due to a combination of downward surprises to growth in the first half of the year, and an intensification of European sovereign debt and banking woes. Indeed, in light of the intensification of these problems, downside risks are increasing.

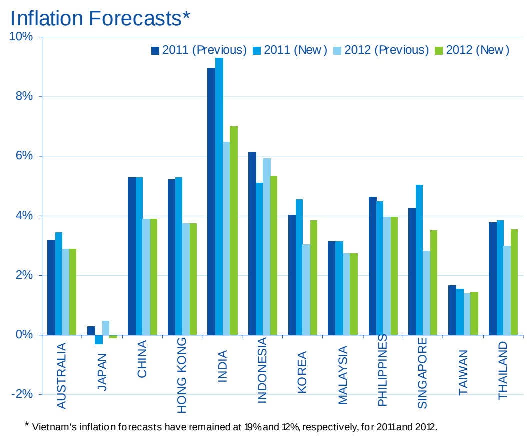
As we have argued on previous occasions, Asia, as a region, is well-positioned to weather the fallout of lower global growth and financial market volatility. However, given the region's export dependence and financial market openness, it is far from immune. To capture the likely impact of slower global growth in our baseline, we have lowered our growth projections for Emerging Asia to 7.6% in 2011 and 2012, a downward revision of 0.3 and 0.2 percentage points, respectively. Within this group, we have lowered our growth projections for China to 9.2% and 8.9% in 2011 and 2012, respectively (a downward revision of 0.2 percentage points in both years). Our biggest downward revisions, for the most part, are for the region's smaller and more export dependent economies. At the same time, our inflation projections have been revised modestly upward, to take into account higher-than-expected outturns through the first three quarters of 2011.

Chart 7
Modest downward revisions to our growth forecasts



Source: CEIC and BBVA Research

Chart 8
Most inflation projections have been raised due to higher than expected outturns



Source: CEIC and BBVA Research

Recent activity indicators for the region have been holding up surprising well. However, while we had previously expected a rebound of activity during the second half of 2011, with global growth weakening, that no longer appears likely. Nevertheless, under our baseline, Asia's growth should remain reasonably strong, fueled by continued growth in China and India, and strong domestic demand. There is also room for policy stimulus to counter the impact of weaker external demand. Indeed, we have lowered our interest rate forecasts, as most of the region's central banks now appear on hold through the remainder of the year. There is also scope for fiscal stimulus if needed.

However, downside risks have increased markedly. The revisions above mainly reflect weaker demand through the trade channel. If financial sector stresses overseas were to continue, such spillovers would warrant further and more significant downward revisions to our growth forecasts in the period ahead.

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Calendar Indicators

China	Date	Period	Prior	Cons.
Industrial Profits YTD (YoY)	27-Sep	AUG	28.3%	- -
HSBC Manufacturing PMI	30-Sep	SEP	49.9	- -
PMI Manufacturing	1-Oct	SEP	50.9	- -
Hong Kong	**Date**	**Period**	**Prior**	**Cons.**
Exports (YoY)	27-Sep	AUG	9.3%	8.2%
Imports (YoY)	27-Sep	AUG	10.2%	10.0%
Japan	**Date**	**Period**	**Prior**	**Cons.**
Corp Service Price Index (YoY)	27-Sep	AUG	-0.5%	-0.4%
Retail Trade (MoM) SA	29-Sep	AUG	-0.3%	0.2%
Overall Hhold Spending (YoY)	30-Sep	AUG	-2.1%	-2.8%
Jobless Rate	30-Sep	AUG	4.7%	4.7%
CPI (YoY)	30-Sep	AUG	0.2%	0.1%
CPI Ex-Fresh Food (YoY)	30-Sep	AUG	0.1%	0.1%
Industrial Production (MoM)	30-Sep	AUG P	0.4%	1.5%
Vehicle Production (YoY)	30-Sep	AUG	-8.9%	- -
Construction Orders (YoY)	30-Sep	AUG	5.7%	- -
Housing Starts (YoY)	30-Sep	AUG	21.2%	4.5%
Philippines	**Date**	**Period**	**Prior**	**Cons.**
Total Imports (YoY)	27-Sep	JUL	6.6%	- -
Singapore	**Date**	**Period**	**Prior**	**Cons.**
Industrial Production (MoM) SA	26-Sep	AUG	0.3%	-4.5%
Bank Loans & Advances (YoY)	30-Sep	AUG	27.8%	- -
Korea	**Date**	**Period**	**Prior**	**Cons.**
Industrial Production (MoM)	30-Sep	AUG	-0.4%	- -
Thailand	**Date**	**Period**	**Prior**	**Cons.**
Exports (YoY)	30-Sep	AUG	36.4%	- -
Imports (YoY)	30-Sep	AUG	13.1%	- -
Vietnam	**Date**	**Period**	**Prior**	**Cons.**
CPI (YoY)	26-30 SEP	SEP	23.0%	- -
GDP Constant Prices YTD (YoY)	26-30 SEP	3Q	5.6%	- -
Exports YTD (YoY)	26-30 SEP	SEP	33.7%	- -
Imports YTD (YoY)	26-30 SEP	SEP	25.4%	- -
Retail Sales YTD (YoY)	26-30 SEP	SEP	22.2%	- -
Industrial Production (YoY)	26-30 SEP	SEP	5.8%	- -

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

Forecast: 51.6	Consensus: not available yet	Prior: 50.9

Comment: Activity indicators have held up well so far, in line with our expected soft landing scenario. However, with downside risks to global demand increasing, markets will be watching the forthcoming monthly Purchasing Managers' Index (PMI) for signs of a more significant slowdown. A flash estimate of the private sector PMI for September (Markit) suggests some weakening of manufacturing sentiment. Nevertheless, with recent activity data continuing to show strength, we expect the official PMI for September to increase from last month, although this mainly reflects seasonality (despite the statistic agency's efforts to de-seasonalize the series). Market impact: A lower-than-expected reading, especially a decline from the previous month or an outturn below the 50+ expansion threshold, could dent sentiment about the growth outlook.

Calendar Events

Taiwan – Benchmark Interest Rate, September 29	Current	Consensus
We expect no change in the benchmark rate.	1.875%	1.875%

Markets Data

STOCK MARKETS

INDEX	Last price	% change over a week	Year to date	% Change over 1 Y
China – Shanghai Comp.	2438.9	-1.7	-13.1	-5.9
Hong Kong – Hang Seng	17677.0	-9.1	-23.3	-19.8
Taiwan – Weighted	7089.5	-6.4	-21.0	-13.6
Japan – Nikkei 225	8560.3	-3.4	-16.3	-10.5
Korea – Kospi	1723.0	-6.4	-16.0	-6.0
India – Sensex 30	16361.2	-3.4	-20.2	-17.6
Australia – SPX/ASX 200	3941.2	-5.0	-16.9	-14.9
Singapore – Strait Times	2675.9	-4.1	-16.1	-13.2
Indonesia – Jakarta Comp	3348.3	-12.7	-9.6	0.3
Thailand – SET	972.3	-5.9	-5.9	2.7
Malaysia – KLCI	1372.8	-4.1	-9.6	-5.9
Philippines – Manila Comp.	3920.4	-8.6	-6.7	-3.6

Last update: Friday, 11.45 Hong Kong time.

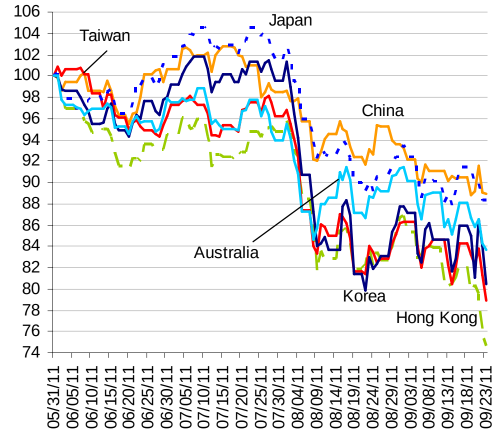
FOREIGN EXCHANGE MARKETS

CURRENCY	Spot	% change over a week	Forward 3-month	Forward 12-month
China (CNY/USD)	6.39	-0.15	6.44	6.45
Hong Kong (HKD/USD)	7.80	-0.09	7.79	7.77
Taiwan (TWD/USD)	30.6	-3.45	30.55	30.14
Japan (JPY/USD)	76.3	0.67	76.18	75.78
Korea (KRW/USD)	1193	-6.80	1198	1198
India (INR/USD)	49.6	-4.07	50.42	51.55
Australia (USD/AUD)	0.98	-5.40	1.03	n.a.
Singapore (SGD/USD)	1.30	-4.61	1.30	1.30
Indonesia (IDR/USD)	8953	-1.68	9400	9711
Thailand (THB/USD)	30.8	-1.40	31.00	31.45
Malaysia (MYR/USD)	3.18	-3.04	3.20	3.23
Philippines (PHP/USD)	43.9	-1.26	44.08	44.25

Last update: Friday, 11.45 Hong Kong time.

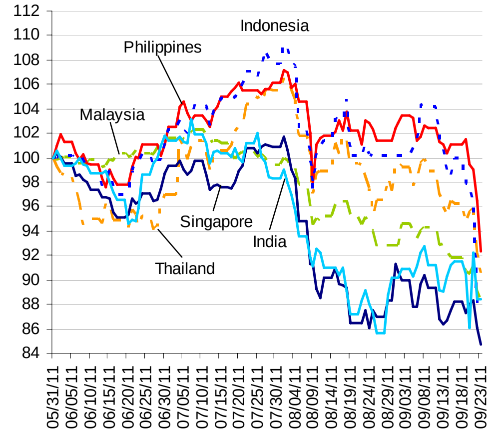
Charts

Chart 9
Stock Markets



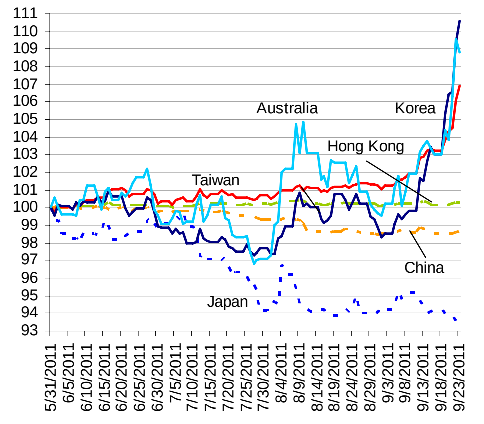
Source: BBVA Research and Bloomberg

Chart 10
Stock Markets



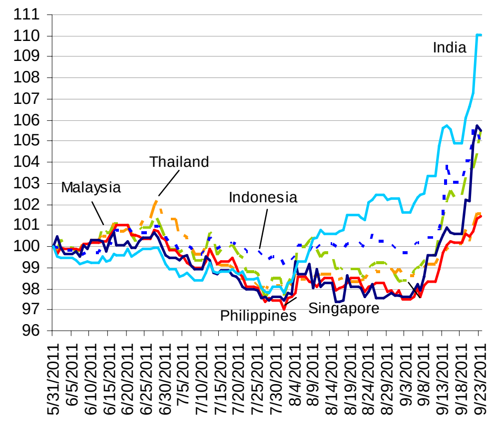
Source: BBVA Research and Bloomberg

Chart 11
Foreign Exchange Markets



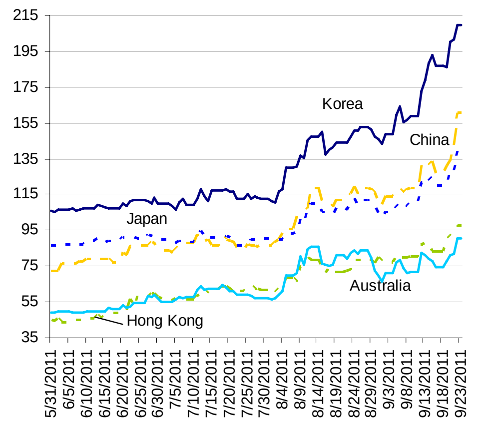
Source: BBVA Research and Bloomberg

Chart 12
Foreign Exchange Markets



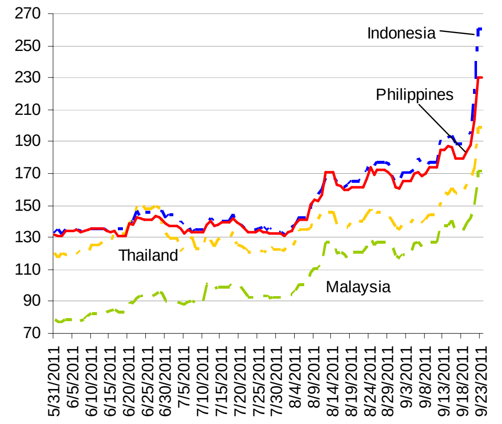
Source: BBVA Research and Bloomberg

Chart 13
Credit Default Swaps



Source: BBVA Research and Bloomberg

Chart 14
Credit Default Swaps



Source: BBVA Research and Bloomberg

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