

Asia/Oceania Weekly Outlook

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- **Costs to stay elevated in China but inflation could peak soon; CNY to strengthen**
- **Japan's Asian links will save it from itself for the time being; growth to slow in 2011**
- **Australian dollar correction to be short-lived as terms of trade reach record levels**
- **Economic activity in New Zealand set for a rebound with the turn of the year**

Costs to stay elevated in China but inflation could peak soon; CNY to strengthen

The People's Bank of China (PBoC) decided for a second 25 basis point (bps) increase in the benchmark interest rate over Christmas, as yearly inflation continued to climb up to 5.1% in November. Double-digit food costs have been the main driver of the recent upsurge in the annual inflation rate, with base effects playing a relevant role given food deflation during the second half of 2009. While costs are likely to remain elevated in coming months, in the a context of building economic momentum, annual inflation could peak soon on the back of dissipating base effects. Although producer price gains also accelerated in November, they remain below mid-2010 peaks. Rising price pressures have yet to disseminate to the rest of the economy as non-food price gains remain below 2%, having reached 1.9% y/y in November. As part of the recognition by Chinese authorities of the higher cost environment, the PBoC has raised its yearly inflation objective to 4% from 3% in 2010 (CPI data for December will be published on January 19th, 2011). We expect the PBoC to persist in its monetary normalization drive, as interest rate increases pick up pace in 2011 after the 50 bps rise of 2010. Further lifts in credit costs will be aimed mainly at combating asset price inflation fueled by loan growth and perceptions of improving economic prospects. With exports expanding by over 30% y/y, and given strong momentum in local retail sales, authorities' confidence on the country's economic performance should also lead to further Chinese yuan (CNY) appreciation. The CNY will accelerate its strengthening bias in 2011 as part of a concerted policy to maintain inflation in check. We expect the CNY to close at a 6.1 per US dollar rate in 2011 and 5.8 in 2012.

Japan's Asian will save it from itself for the time being; growth to slow in 2011

While global uncertainty will continue to support the Japanese yen (JPY) as a safe heaven asset, limited fiscal flexibility and low growth will condition its performance during 2011. The JPY gained 12% against the US dollar in 2010 as it played the safe heaven role in the midst of uncertainty about the pace of the global economic recovery. An agile rebound in Japan's output during 2010 also aided the JPY, as growth in Japan (estimated at 3.4% in 2010) was one of the fastest among major economies. Proximity to China will remain an important factor going forward, as the mainland remains a key target market for Japanese manufacturers. While Japanese foreign shipments have adjusted downwards as of the third quarter of 2010, exports to China and the US remained on an upward trend through November, with the former country having become Japan's main export market as a legacy of the global recession. Slower expansion in foreign sales will be somewhat compensated by resilient domestic demand indicators, as labour market conditions retain a favourable tone. Yearly wage gains in Japan crossed positive territory in October



for the first time in over two years. However, the recently approved fiscal impulse package worth 1% of GDP will dwarf in comparison to last year's government stimulus. The effects will compound leading the economy back to sluggish GDP growth in 2011. In order to reverse disinflationary pressures and prevent further contractions in spending, monetary authorities are bound to continue to provide liquidity to the economy in the form of further expansion of the central bank's balance sheet through asset purchases.

Australian dollar correction to be short-lived as terms of trade reach record levels

The outlook for the Australian dollar (AUD) remains positive impinged by carry-trade dynamics and the country's terms of trade gains. Persistent growth out of China and India continue to underpin commodity price increases supporting the resource-linked AUD. Improving market conditions for Australia's exports have lifted the profile of the country's firms whose intentions for additional capital spending have bettered the conditions of the local market. While household borrowing and consumption has become restrained despite high levels of confidence, employment growth remains solid. On the back of the favourable landscape for both domestic and foreign demand, the Reserve Bank of Australia (RBA) decided to raise the cash rate by 100 bps to 4.75% during 2010, with the last increase taking effect after the November monetary policy meeting. As outlined in the minutes published in December the board of governors of the RBA recognized the prevalence of a mildly restrictive monetary policy stance as adequate within the context of a strengthening AUD. The monetary authorities pointed to inflation expectations remaining in line with the medium-term inflation target, notwithstanding an expected pickup in wage growth given solid local labour market conditions.

We expect the RBA to retain a monetary tightening stance which will translate into an anticipated 75 to 100 bps increase in the cash rate through 2011. Rising interest rate and GDP growth spreads will continue to support the AUD through 2012.

Economic activity in New Zealand set for a rebound with the turn of the year

The outlook for the New Zealand dollar (NZD) remains positive. Notwithstanding signs of a slowdown in economic activity, the country remains in line to continue to exploit its proximity to Australia and the Asian region as regional export demand remains steady. Rebuilding efforts after the September earthquake in Christchurch City will lead to a rebound from unexpected GDP contraction in the third quarter (-0.2%). Persistent terms of trade gains combined with recent NZD weakness are likely to provide a lift to foreign shipments during the turn of the year. While household spending remains subdued, evidence of a turning point in the labour market is likely to improve confidence. The country's jobless rate fell to 6.4% in the September quarter, from the 6.9% rate three months earlier. Favourable employment conditions are translating into wage gains with yearly pickup in non-tradable goods prices running ahead of headline inflation through the second half of 2010. While annual inflation remains subdued at 1.1% y/y, it is bound to start to build up on the back of rising economic momentum. The Reserve Bank of New Zealand (RBNZ) decided to keep the benchmark rate at 3% after its last monetary policy meeting of 2010 on December 9th. RBNZ Governor Allan Bollard pointed to the adequacy of the current monetary stance as low borrowing costs are still needed to support the recovery in activity. We expect the RBNZ will move towards further interest rate normalization during 2011 as the inflationary scenario further reflects improving local demand conditions.

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