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Asia/Oceania Weekly Outlook



- **Rate hikes in Australia and Malaysia, Indonesia on hold**
- **Asian exports and inflation trending higher, but performances vary**
- **Strong profit recovery points to a turnaround in Japanese investment and employment**
- **China aims to dampen growth in 2010 to ensure that inflation remains well contained**

Rate hikes in Australia and Malaysia, Indonesia on hold

The Reserve Bank of Australia's (RBA) bias towards monetary policy tightening remains intact following its March 2nd decision to raise the Cash Rate another 25 basis points to 4.0%. In his official announcement, Governor Glenn Stevens made it clear that the process of interest rate normalization is not yet over: "[W]ith growth likely to be close to trend and inflation close to target over the coming year, it is appropriate for interest rates to be closer to average. Today's decision is a further step in that process." (His complete statement can be found on the RBA's website: <http://www.rba.gov.au/>.) The adjustment - the fourth such decision in the past five policy meetings - followed an array of positive economic indicators, including a solid 1.2% m/m advance in retail sales in January alongside further gains in employment and a strong (9.5% m/m) rebound in private new home sales (though building approvals slumped 7.0% m/m).

Fourth quarter national accounts data released the day following the RBA decision confirmed the strength of the economic recovery, as output rose a solid 0.9% q/q (2.7% y/y), led by a 4.9% q/q rebound in business investment and underpinned by a further 0.7% q/q gain in consumer spending. Yet, as we noted last week, wage pressures were muted through the final three months of 2009, increasing by a modest 0.6% q/q (2.9% y/y). Trade was a heavy drag on economic activity in the fourth quarter, pulling the growth figure down by 1.3 percentage points. The RBA is not concerned by the further widening of the current account shortfall to a 7-quarter high of A\$17.5 billion in Q4. Nevertheless, while currency markets are now focused on fiscal rather than balance of payments deficits, the persistent heavy reliance on foreign savings to sustain domestic spending does pose longer-term risks to chronic current account deficit countries; at the same time, we believe that the period of market support for commodity-sensitive currencies still has some distance to run, setting the stage for a fresh rally in the Australian dollar before a period of stability and subsequent retreat.

Bank Negara Malaysia (BN) Governor Zeti Akhtar Aziz has been signalling the prospect of higher interest rates for several months. As a result, markets were generally indifferent to BN's March 4th decision to commence the process of interest rate normalization by nudging its benchmark interest rate up 25 basis points to 2.25%. The benchmark equities index - the KLCI - dipped marginally on the day as did the yield on the benchmark 10-year government bond, and the ringgit appreciated slightly vis-à-vis the US dollar. The monetary authorities expect inflation to "remain moderate" even as growth accelerates; the consumer price index rose by an 8-month high of 1.3% y/y in January. Thus, the rate decision was entirely preemptive and was designed to avoid "the risk of financial imbalances that could undermine the economic recovery process" (the full statement can be found at BN's website: <http://www.bnm.gov.my/>). Although the pace of recovery in industrial output and exports has lagged a number of other emerging Asian economies, Malaysia is on track to grow by at least 4% this year, following a relatively moderate 1.7% contraction in 2009. With interest rates trending higher and economic conditions on the mend (GDP rose 4.5% y/y in the final quarter of 2009, the first advance in a year), we expect the ringgit's moderate appreciating bias to persist through the balance of the year, taking the exchange rate (currently 3.36 per US dollar) to 3.25 by end-2010.

With consumer price inflation (3.8% y/y in February) still comfortably below Bank Indonesia's (BI) 2010-11 target of 5% \pm 1%, the central bank remains on watchful hold, as it opted to leave its benchmark interest rate unchanged at 6.5% following the March 4th policy board meeting. While board members are becoming more upbeat about economic growth prospects, they also maintain that inflation will remain contained, expressing confidence that "no significant inflationary pressures will emerge at least during the



first half of 2010, with inflation for 2010 overall expected within the targeted range” (the complete statement can be found at BI’s website: <http://www.bi.go.id/web/en>).

Asian exports and inflation trending higher, but performances vary

A recovery in exports has been a basic characteristic of the Asia/Pacific economies in recent months; however, the rate of growth varies substantially from one country to another. **Indonesian** exports (in US dollar terms) increased at a 50%+ y/y pace for a second consecutive month in January, resulting in a substantial US\$2.0 billion trade surplus despite the 45% jump in imports. In a similar vein, **Korean** exports have surged about 40% y/y through the first two months of 2010. **Indian** exporters are not keeping up with their East Asian competitors. Foreign sales rose a modest 11.5% y/y in January, following an even more moderate gain of 9.3% the previous month; with imports increasing by 35.5% y/y, the January trade deficit widened to a 14-month high of US\$10.4 billion; importantly for India, the large trade shortfalls are substantially offset by foreign exchange earnings stemming from business services, workers’ remittances and tourism. Despite lower contract prices for iron ore and coal compared with a year ago and the constraining impact of an appreciating currency, **Australian** exports are also registering solid gains (in US\$ terms), increasing by 15.0% y/y in January to US\$14.6 billion, though a much stronger import performance (+27% y/y in US dollar terms) resulted in a trade deficit of US\$1.1 billion, compared with a year-earlier surplus of US\$0.3 billion.

As is the case with exports, consumer prices across emerging Asia are above year-earlier levels, but the pace of inflation varies considerably from country to country. **India** has assumed the dubious distinction of being the highest inflation nation among the major regional economies - and price pressures are still intensifying. This sets the stage for higher interest rates in India following the Reserve Bank’s April policy meeting. A moderate buildup in pressures is evident in **Korea**, where the headline consumer price inflation rate through the first two months of the year has averaged 2.9%, compared with an average of 2.4% through the final quarter of 2009; however, the core CPI has slipped back to a 3-year low of 1.9% y/y. A sharp increase in **Taiwanese** inflation was evident in February, as the headline consumer price index was up 2.4% y/y compared with 0.3% in January; the run-up is partially attributable to the timing of the Lunar New Year, but the data also suggest that the period of deflation (consumer prices hovered below year-earlier levels through almost all of 2009) is over, setting the stage for a

possible modest rate increase when the central bank policy board meets on March 25th.

Strong profit recovery points to a turnaround in Japanese investment and employment

We remain hopeful that the Japanese economy will grow by about 1½% this year, following a 5% decline in output in 2009. With corporate profits increasing by more than 30% q/q for a third consecutive quarter in the final quarter of 2009, and the manufacturing sector reporting sharp gains in output and capacity utilization since early-2009, prospects for a turnaround in business investment are improving. Moreover, we anticipate a modest rise in consumer spending this year. With total employment rising by 1.0% in just two months, Japan’s jobless rate fell below the 5.0% threshold for the first time in more than a year and a half in January. This, in turn, helped to nudge salaries above year-earlier levels for the first time since May 2008. Although the increase was a marginal 0.1%, this occurred alongside a 1.3% y/y decline in the headline inflation rate, thereby giving an additional boost to wage-earners’ spending power; indeed, official figures last week reported that household expenditures - adjusted for inflation - rose 1.7% y/y in January.

China aims to dampen growth in 2010 to ensure that inflation remains well contained

Premier Wen Jiabao’s annual address to the National People’s Congress offered little in terms of economic policy surprises; rather it served as a recapitulation of previously-announced measures aimed at slowing growth to a sustainable level and containing the risks of inflation, whether at the consumer or asset price levels. The economic growth target of 8% should not be taken literally, but is a signal that the authorities have no intention of countenancing a rate of expansion of more than 10% (10.7% y/y in the final quarter of 2009); however, the inflation target of “around 3%” likely represents a ceiling, as the government is acutely aware of the socially destabilizing impact of high rates of inflation. Government spending growth is set to slow to 11.4% y/y (with military expenditures up a surprisingly muted 7.5%) from more than 20% in 2009, though the administration will continue to pursue efforts of narrowing the income gap between rural and urban residents. Premier Wen confirmed the official bank lending target of 7.5 trillion yuan (down more than 20% from 2009), and stressed the importance of curbing property speculation. As expected, he also reiterated the commitment to a “basically stable” exchange rate, a policy that we believe will not preclude moderate appreciation vis-à-vis the US dollar in 2010.

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