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Asia – Gauging inflation risk

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- Monetary tightening and other inflation prevention measures are still needed in Asia
- Real policy rates remain low in most economies and could fall further as inflation rises
- We expect TWD and KRW to appreciate further on a trade-weighted basis in 2011
- Vietnam, Indonesia, Philippines and Thailand are vulnerable to commodity-price shocks
- Low rates in Singapore and HK fuelling lending growth, despite macro-prudential measures

Summary

A strong recovery brings the risk of rising inflation

Following a swift recovery in Asia, along with the prospects of capital inflows into the region, many Asian central banks have voiced concerns about the risk of inflation. By Q2-2010, the level of economic activity in all Asian economies had returned to pre-crisis levels. In some countries, such as China and Singapore, the current level of activity is 15-20% above pre-crisis levels in real terms. Meanwhile, although policy rates have been raised in some Asian economies, they mostly remain below long-term averages after adjusting for inflation, with many real policy rates still negative. For Asian currencies, with the exception of the Hong Kong dollar (HKD), all major Asian currencies have appreciated on a nominal effective exchange rate (NEER) basis in 2010. However, the HKD, Korean won (KRW), Indonesian rupiah (IDR), Indian rupee (INR) and Taiwan dollar (TWD) remain below their average nominal effective exchange rate (NEER) levels between 2003 and 2008. This implies that there is still plenty of scope for interest-rate tightening as well as currency appreciation, in order to pre-empt the risk of consumer- and asset-price inflation.

We also note that Asia is vulnerable to global commodity prices, in particular food and energy, even though we do not expect these to experience a similar short-term spike to that in 2008. Economies with lower GDP per capita are particularly exposed, since they spend a higher proportion of their income on these basic necessities. China has already flagged the possibility of price controls on selected food and energy products, as well as subsidies for low-income groups. However, the experience of 2008 suggests that these measures will not be effective if global commodity prices are sustained.

Taking into account the current policy stance and historical inflation volatility, we believe that Indonesia, Vietnam, the Philippines and Thailand will be particularly vulnerable to a sudden pick-up in inflation. Incidentally, Indonesia and Philippines have yet to tighten monetary policy in the current interest-rate cycle. Vietnam has been forced to hike its base rate to support the Vietnamese dong (VND). Such an inflation risk would force policy makers to become more hawkish in 2011.

Important disclosures can be found in the Disclosures Appendix

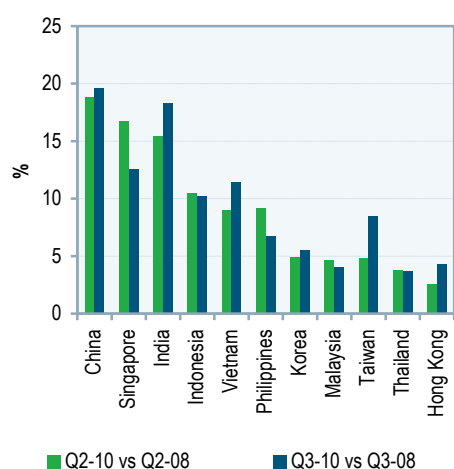




From interest-rate normalisation to tightening

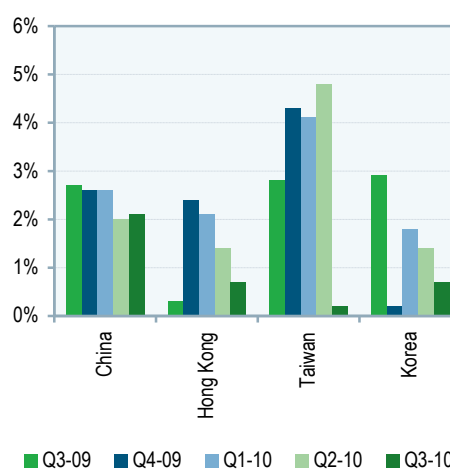
Taking stock of the current recovery, we note that all the Asian economies had made a full recovery from the global financial crisis by Q2-2010. In China, Singapore, India and Indonesia, the level of economic activity in Q2-2010 was 10-20% above that of Q2-2008 (Chart 1), the pre-crisis level. That said, we note that growth momentum has slowed in some markets, as reflected by the Q3-2010 q/q growth figures (Chart 2 and 3). Malaysia, Singapore and Thailand contracted on a q/q basis in Q3; this was the second consecutive quarter of q/q contraction for Thailand. This weaker growth momentum is expected to extend into Q4-2010. Meanwhile, Hong Kong, Taiwan and South Korea have managed to maintain positive q/q growth, but their growth rates have also eased considerably. China and Indonesia are the two economies that have shown some resilience in their recovery momentum.

Chart 1: Real GDP is now above the pre-crisis level for all Asian economies



Sources: CEIC, Standard Chartered Research

Chart 2: Real GDP growth in North East Asia q/q

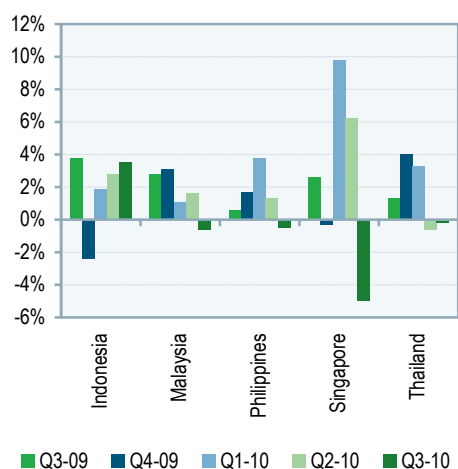


Sources: CEIC, Standard Chartered Research

The deceleration is not surprising, since the inventory restocking in H1-2010 is coming to an end, and we have warned for some time that this one-off boost to growth would fade in H2-2010. This is being reflected in the moderation in export growth. The important point is that local consumption momentum is still relatively strong, which will still require tightening action by central banks to pre-empt the risk of inflation in quarters ahead. Job markets in the region have enjoyed a strong recovery. While unemployment rates, as shown in Chart 4, have yet to return to their pre-crisis lows, we observe that all the jobs lost during the crisis have been re-generated. The positive wealth effect from asset markets, including equities and real estate, has also boosted Asian consumers' 'feel-good' factor. Strong consumption has facilitated headline expansion, but also raised the risk of demand-driven inflation in the region.

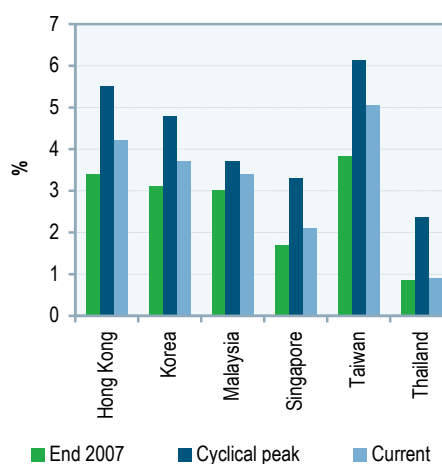


Chart 3: Real GDP growth in South East Asia
q/q



Sources: CEIC, Standard Chartered Research

Chart 4: Sizeable drop in jobless rates in Asia is supporting consumption

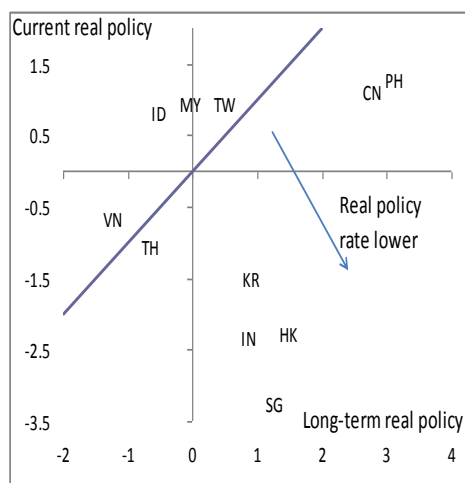


Sources: CEIC, Standard Chartered Research

Real policy rates in Asia remain accommodative. Chart 5 plots the current level of policy rates adjusted for inflation, shown on the vertical axis, and their historical long-term average (between 2003 and 2008), shown on the horizontal axis. Asia can be divided into three groups:

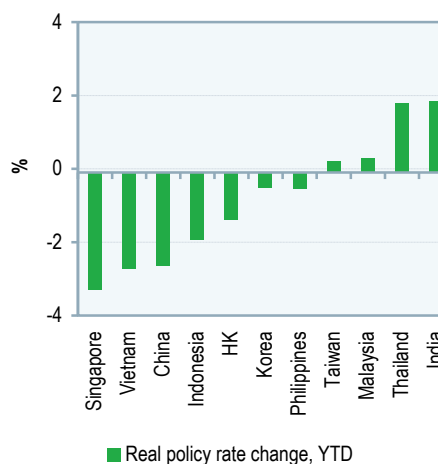
- 1) Positive current real policy rate, in line with the long-term average: Malaysia, Indonesia and Taiwan
- 2) Positive current real policy rate, but below the long-term average: China, Philippines
- 3) Negative current real policy rate: Hong Kong, India, South Korea, Singapore, Thailand and Vietnam

Chart 5: Current real policy rates in most Asian economies are still below long-term averages



Sources: CEIC, Standard Chartered Research

Chart 6: Real policy rates have dropped in Asia, owing to rising inflation



Sources: CEIC, Standard Chartered Research



This tells us that the current real policy rates for Indonesia, Malaysia and Taiwan are broadly in line with their long-term averages, but not significantly higher. Hence, these economies can be considered to have neutral interest-rate policies. For the rest of the region, with real policy rates in outright negative territory, or remaining below their long-term averages, current interest rate policy stances are still accommodative; further tightening is required for interest rates to return to normal.

This does not necessarily imply that Malaysia, Indonesia and Taiwan can sit back and leave their interest-rate policies at current levels. Rising inflation is also pushing real policy rates lower in many economies in Asia. As shown in Chart 6, the year-to-date change in the real policy rate has been negative in Asia, except for India, Thailand, Malaysia and Taiwan. The drop in real policy rates is driven by higher inflation as well as tepid tightening by the respective central banks. Furthermore, if growth momentum surprises on the upside in coming quarters, the closing of the output gap will accelerate, which would call for even more aggressive action by Asian central banks.

In 2008, many central banks argued that higher inflation, led by an exogenous rise in commodity prices, could not be effectively handled by interest-rate policy. They believed that the local cost of borrowing would have little impact on calming domestic food and energy prices, owing to the low elasticity of these daily necessities against changes in interest rates. Hence, core inflation, which excludes food and energy, could be a more effective policy objective for central banks. Yet in practice, the Bank of Thailand (BoT) is the only central bank in Asia that explicitly targets core inflation. The Bank of Korea (BoK), Bank Indonesia (BI) and Bangko Sentral ng Pilipinas (BSP) are the other three regional central banks that have explicit inflation targets using headline inflation.

Moreover, wage demand, as a function of inflation expectations, is likely to be driven by headline inflation instead of core inflation. As a result of the improving labour-market conditions, wages are gradually rising. Singapore's average monthly earnings started to rise on a y/y basis in Q1-2010 after four consecutive quarters of decline. They rose 5.8% y/y in Q2-2010. After contracting for three quarters between Q1-2009 and Q3-2009, Hong Kong's nominal wage index has also been improving, recording 2.2% y/y growth in Q2-2010. In some economies, such as Indonesia and Vietnam, headline inflation, instead of core inflation, is important to maintaining local investor confidence in the local currency. Sell-offs in the IDR and VND in the past were often triggered by a rise in inflation expectations, with local interest rates not sufficiently high to protect local-currency asset values. Therefore, we believe central banks will need to consider raising borrowing costs, even though headline inflation is largely driven by commodity prices, to maintain investor confidence in local currencies.

Currency appreciation will help too

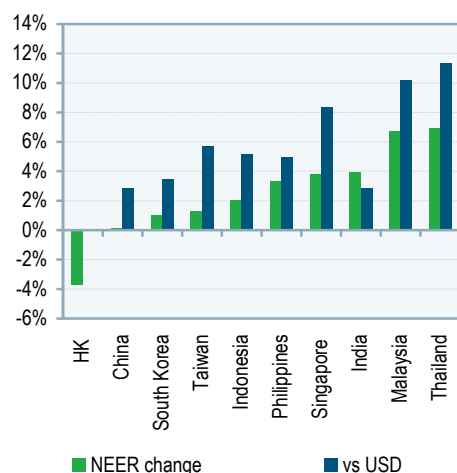
In addition to interest-rate tightening, some central banks in Asia tolerated currency strength in the first three quarters of 2010 to help mitigate imported inflation. Currency appreciation will also help to manage capital inflows. In particular, India, Thailand, Singapore, Malaysia and Indonesia have led the way in allowing their currencies to appreciate on a trade-weighted, or NEER, basis. These South East Asian currencies have also seen significant gains against the US dollar (Chart 7). Currency appreciation in Asia did slow entering Q4-2010 as governments and central banks started to become concerned about the impact of currency strength on export performance, especially given the growing headwinds in the US and Europe.

From a historical perspective, the current NEER levels for the Singapore dollar (SGD), Thai baht (THB), Chinese yuan (CNY), Malaysian ringgit (MYR) and Philippine peso (PHP) are above their averages observed between 2003 and 2008 (Chart 8). Meanwhile, the current NEER levels of the IDR, INR, TWD, HKD and KRW remain below their long-term averages.

Taking into account prospects for capital inflows into Asia, we continue to expect Asian currencies to appreciate in 2011, although the extent of such appreciation will be determined by the appetite of central banks and governments. Observing the currency appreciation since the recovery and current levels versus historical averages, Taiwan and South Korea need to permit their currencies to play a much bigger role in fighting inflation. Since we do not expect any change in the USD-HKD exchange rate link in the foreseeable future, macro-prudential measures, such as those aimed at cooling the domestic residential real-estate market, will have to lead the charge in combating asset-price inflation.

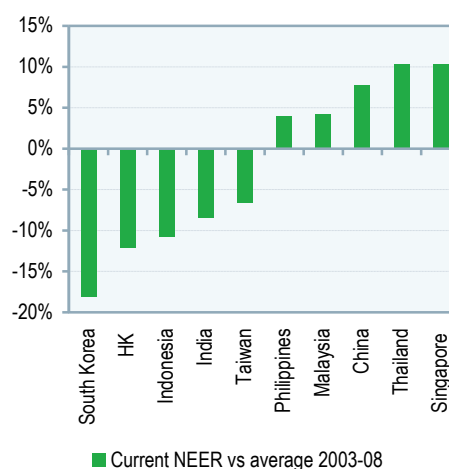


Chart 7: SEA led the way in appreciation on NEER basis and against the USD (Q1 to Q3 2010)



Sources: BIS, Standard Chartered Research

Chart 8: Current NEERs of KRW, HKD, IDR, INR and TWD remain below their long-term averages



Sources: BIS, Standard Chartered Research

The current inflation picture in Asia: who is at risk?

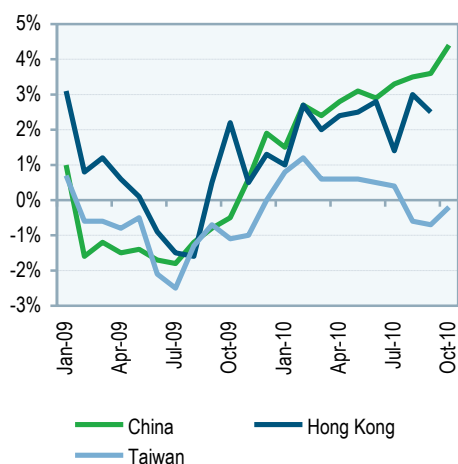
Inflation across Asia has been generally stable (Charts 9-11), with the exception of China and Vietnam, where rising inflation trends are drawing the attention of local market participants. In China's case, food inflation led to above-average headline CPI inflation between July and October. This has already led to greater guidance from the authorities on controlling prices, as well as hikes in reserve requirements and interest rates. Vietnam's consumer price increase in September and October was also sizeable, with the food component contributing as much as 70% of headline inflation. For the rest of the region, there is little immediate threat of inflation, but one should not be complacent over the speed of the inflation pick-up. In particular, headline inflation tends to correlate closely with food prices, because of the large share of food in household spending in the region. Higher inflation can also strain fiscal policy in the form of higher subsidy payouts and compensation for losses to state-owned enterprises if price controls are implemented. Our commodity forecasts depict an orderly and modest rise in food and energy prices in 2011; these are factored into our inflation forecast for Asia. Yet, given the inflation spike in 2008 and the fact that underlying growth momentum in Asia continues to be robust, one needs to take into account the upside risk to inflation.

The volatility of inflation should also be noted. Vietnam, Indonesia, the Philippines and Thailand have significant volatility in their consumer-price inflation (shown along the horizontal axis of Charts 10 and 11), which implies that the current benign environment could deteriorate more rapidly than other Asian economies. Inflation can rise with a vengeance. This is essentially because of the greater proportion of household spending by these economies on food and energy, which leaves them exposed to the volatility of global commodity prices. The scatter plot in Chart 12 shows the correlation between share of food and transportation in the CPI basket and the corresponding inflation volatility between 2005 and 2009. This was evident in 2008, when low-income economies suffered much higher inflation than high-income economies such as Hong Kong, Taiwan and Singapore.

We also note that price controls, which may be effective in the short run to limit inflation, can exacerbate inflation volatility if the rise in global commodity prices is sustained. Pent-up price pressure will eventually force the authorities, possibly because of the rapidly expanding fiscal burden of subsidies, to permit price rises. Leakage and smuggling also undermine the efficacy of price controls. One-off price increases in such circumstances are typically large, in order to restore market equilibrium.

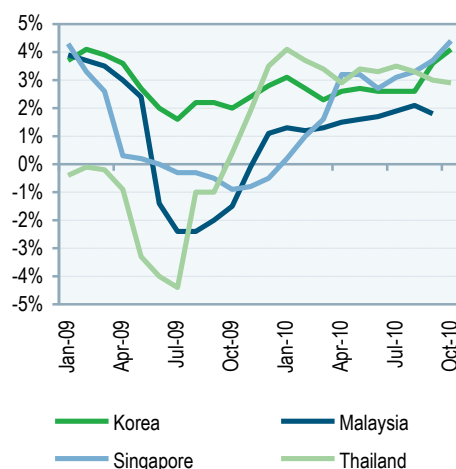


Chart 9: Inflation y/y (China, Taiwan, Hong Kong)



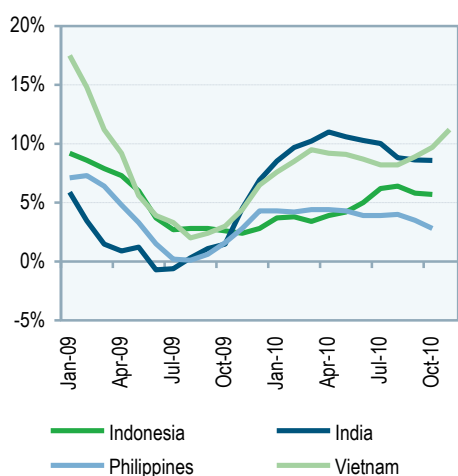
Sources: CEIC, Standard Chartered Research

Chart 10: Inflation y/y (Korea, Malaysia, Thailand, Singapore)



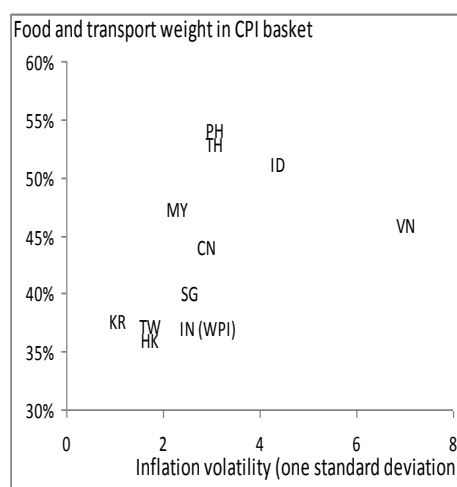
Sources: CEIC, Standard Chartered Research

Chart 11: Inflation y/y (Indonesia, India, Philippines, Vietnam)

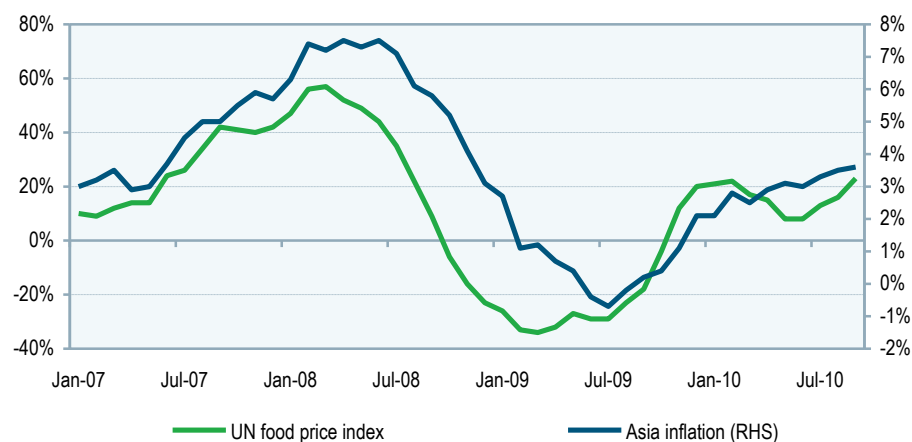


Sources: BIS, Standard Chartered Research

Chart 12: Inflation volatility (2005-09) correlates with share of food and energy in the CPI basket



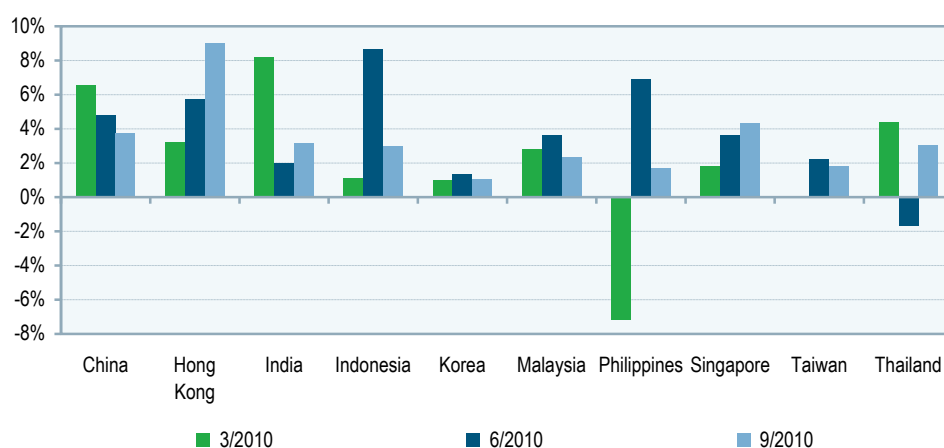
Source: Standard Chartered Research


Chart 13: Asian inflation and its correlation with global food prices


Sources: FAO, Standard Chartered Research

The pick-up in lending growth

The picture of credit growth in Asia is mixed. In Hong Kong and Singapore, persistently low local interest rates led to an acceleration in lending growth in Q3 (Chart 14), especially for the real estate sector. This suggests that macro-prudential measures aiming at cooling property speculation have yet to be fully effective. These two economies hence remain the most vulnerable to a further rise in lending growth. Meanwhile, China's lending growth has decelerated, with Beijing scrutinising the quantity of new lending more closely. Lending growth in South Korea, the Philippines and Taiwan was modest in Q3, with less than 2% q/q growth in total credit outstanding. Credit growth for India, Malaysia and Thailand stood at around 3%. Rising interest rates in these three economies, owing to monetary tightening by their central banks, have brought some moderation in lending growth relative to Q1 and Q2. Thailand's contraction in credit in Q2 can be attributed to the political unrest in Bangkok in April and May.

Chart 14: Credit growth across Asia, q/q


Sources: CEIC, Standard Chartered Research



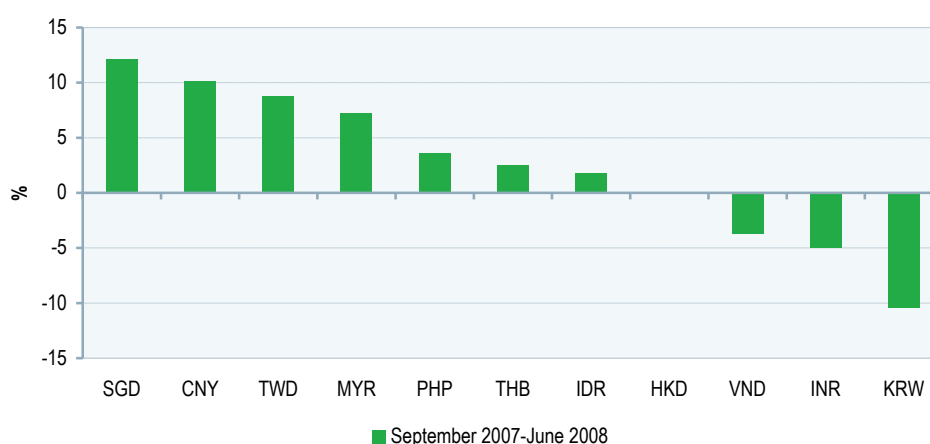
Alternative cooling strategies

In addition to policy-rate increases and currency appreciation, Asian governments are also looking at alternative measures to supplement monetary tightening to pre-empt the risk of inflation. This is particularly important for economies that do not have an active interest-rate policy or whose current interest rate policies are restricted by country-specific issues. Hong Kong and Singapore are the two economies where monetary policy is conducted via exchange rates instead of interest rates; this monetary policy framework has led to exceptionally low domestic borrowing costs. Both governments have implemented measures to cool down their residential real estate markets (see **On the Ground, 27 October, 2010, "Asia – Capital controls gain support"** for a more detailed discussion of these measures).

FX implications

The FX implications of higher CPI inflation in Asia will depend on the policy response. The key question is whether the authorities will tighten monetary policy and allow currencies to appreciate to deal with higher CPI inflation. As a reference, we look at the period from September 2007 to June 2008, when food and energy prices rose sharply. During this period, all Asia ex-Japan (AXJ) central banks, apart from Bank Negara Malaysia (BNM), raised interest rates. Chart 15 lists the performance of AXJ currencies during this period. The chart illustrates that the SGD, CNY and TWD were the best performers, whereas the KRW was the worst performer. It should be noted that the sharp depreciation of the KRW from September 2007 to June 2008 was primarily driven by measures to curb short-term foreign borrowing.

Chart 15: AXJ currency performance versus USD during September 2007-June 2008
SGD, CNY and TWD outperformed, VND, INR and KRW underperformed



Source: Bloomberg, Standard Chartered Research

In our view, higher CPI inflation will be most positive for the SGD, as Singapore's FX policy explicitly takes account of CPI inflation. We expect the Monetary Authority of Singapore (MAS) to maintain its current tight exchange-rate policy in 2011, and see a 40% chance that the MAS will opt for further tightening, most likely via a one-off appreciation of the SGD by re-positioning the policy mid-point. Faster CPI inflation should also be a positive for the CNY, TWD and KRW, as the authorities are likely to combine monetary tightening with exchange-rate appreciation to deal with imported inflation. In 2011, we expect the CNY, KRW and TWD to catch up with the strong 2010 performance of South East Asian currencies.

In contrast, we view upward surprises in CPI inflation as a negative for the VND, INR, PHP, IDR and THB. Vietnam's rampant CPI inflation, too-low interest rates and widening trade deficit will continue to put upward pressure on USD-VND in 2011. There is a risk that Bank Indonesia (BI), BSP, the BoT and the Reserve Bank of India (RBI) will fall behind the curve in terms of raising interest, as they are concerned about driving further capital inflows. This will hurt local asset markets and hence currencies. However, this is not our base case, as we forecast that CPI inflation will remain relatively



-muted in Indonesia, the Philippines, Thailand and India, whereas we expect Indonesia and the Philippines to raise interest rates in Q1-2011. Hence, for now, we maintain our short-term *Overweight* FX ratings on the IDR, PHP, THB and INR. We see the currency implications of sharply rising CPI inflation as broadly neutral for the MYR and HKD. We expect BNM to raise interest rates in Q1, taking the policy rate to 3.50% by end-2011, which should dampen concerns that the central bank will fall behind the curve.

Rates implications

The two key factors to consider when gauging how inflation will impact Asian bond markets are: real yields and the dependence on foreign funding.

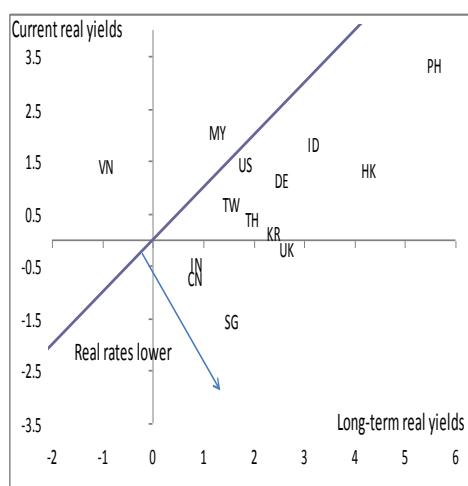
Real yields

From a valuation perspective, the lower real yields are, the less cushion they provide against an inflation shock. For example, if real yields are already close to zero, an inflation shock should urge investors to demand higher nominal yields to compensate. Conversely, if real yields are already very high, an inflation shock may have less of an impact, as investors may not necessarily demand higher yields, as returns are still attractive. Chart 16 shows current real yields versus their long-term averages. In most countries, real yields are lower than long-term averages, which is not surprising given the flood of global liquidity and the flow of funds into EM debt markets. In addition, real yields in developed market such as the US, the UK and Germany are also lower versus long-term averages. We provide a further analysis on individual Asian markets below.

Dependence on foreign funding

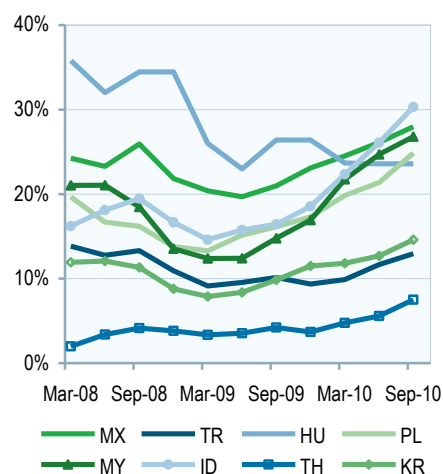
The more dependent a market is on foreign funding, the more vulnerable the market will be to an abrupt foreign exodus caused by an inflation shock. Asian local-currency bond markets have seen strong inflows in 2010. The two countries that have seen the strongest inflows are Indonesia, where foreign holdings as a percentage of the total outstanding rose from 14.6% to 30.3%; and Malaysia, where the share rose from 12.4% to 26.8% (Chart 17). In both cases, foreigners accounted more than 100% of the increase in debt stock year-to-date.

Chart 16: Real yields are lower than long-term averages across Asia, except in Malaysia and Vietnam



Source: Standard Chartered Research

Chart 17: Indonesia and Malaysia have seen particularly strong increases in foreign ownership



Source: Standard Chartered Research



Indonesia is Asia's most vulnerable bond market to an inflation shock

The real yield in Indonesia of 1.3% is lower than its long-term average of 3.2%; coupled with the fact that the bond market is very dependent on foreign funding, this makes Indonesia the most vulnerable bond market to inflation, in our view. An inflation shock should result in locals demanding higher nominal yields to compensate for higher inflation. If there is an exodus of foreigners from the market, prompted by higher yields, there is no natural large domestic buyer, as banks (which have historically been the largest holders of Indonesian bonds) have been buying fewer government bonds at the margin amid robust credit growth over the past three years.

Korea and Malaysia are also vulnerable to an inflation shock, but to a lesser extent than Indonesia

Real yields in Korea are very low, at around 0.5% versus the long-term average of 2.2%. Foreign holdings as a percentage of the total outstanding have also been creeping higher this year, to around 15% from 11%. These two factors put Korea at risk, although to a lesser degree than Indonesia. In Malaysia, foreign participation is very high, which makes the market vulnerable. However, current real yields of around 2% are higher than the long-term average of 1.3%, which will provide some buffer in the event of an inflation shock.

Despite inflation risks in the Philippines and Thailand, dependence on foreign funding is low

The Philippines does not provide data on foreign holdings, but we estimate that they are fairly low at around 6-7% of total holdings, based on custody holdings data. In addition, onshore liquidity is extremely flush, with banks placing over PHP 1trn daily with the central bank in deposit and repo facilities. So even if foreigners leave the market after an inflation shock, there should still be plenty of demand from local banks, which are the largest players in the market, with around 45% of total holdings.

In Thailand, real yields are very low, which presents a risk. However, foreign participation in the bond market is also considered low, with foreigners owning just 7.5% of total LBs (government bonds) outstanding. In addition, Thai bond yields have already adjusted significantly higher after withholding taxes were introduced on 13 October. As in the Philippines, even if foreigners flee the market, we believe that sizeable local demand would help to absorb foreign selling.



Disclosures Appendix

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