

Asia/Oceania Weekly Outlook



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- **People's Bank of China repeats call for a new global reserve asset**
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People's Bank of China repeats call for a new global reserve asset

The People's Bank of China (PBoC) is becoming more vocal in its calls for a new reserve currency that is "delinked from sovereign nations". China holds US\$2 trillion in international reserves - a consequence of high domestic savings rates and official policies geared towards supporting the nation's manufacturing sector - and the potential for asset diversification remains limited. These reserves are largely US dollar denominated assets; indeed, China is now the single largest holder of US treasury assets with more than three-quarters of a trillion dollars. Thus, China finds itself in a policy conundrum: by providing ongoing support to the US fiscal and trade deficits through the acquisition of US government debt, it continues to build up its holdings of assets that are now depreciating, a trend that will become even more problematic for the balance sheet of the PBoC when Beijing resumes its policy of gradual renminbi appreciation vis-à-vis the US dollar. We expect the currency, currently trading near 6.83 per US dollar to reach the 6.3 level by the end of next year.

In reality, this week's statement by the PBoC is simply a reiteration of an April 2009 proposal to create a new, more stable "super-sovereign" reserve currency. Nevertheless, the central bank's determination to keep the issue in the public's eye is indicative of China's growing determination to assume a leadership role on the international stage. In the April paper entitled "Reform the International Monetary System", Governor Zhou Xiaochuan called for "reform of the existing international monetary system towards an international reserve currency with a stable value, rule-based issuance and manageable supply, so as to achieve the objective of safeguarding global economic and financial stability". At that time, Zhou's analysis was very measured, acknowledging the difficult policy challenges faced by the issuers of reserve currencies (without specifically referring to the United States) as well as the rising costs accruing to the users of reserve currencies. Moreover, he explicitly conceded that the "reestablishment of a new and widely accepted reserve currency with a stable valuation benchmark may take a long time". In this undertaking, the governor has suggested that an improved version of the IMF's Special Drawing Rights (SDR), created almost four decades ago, has "the features and potential to act as a super-sovereign reserve currency". In all likelihood, the heightened reliance on an updated SDR to "include currencies of all major economies", possibly weighted by GDP, would occur alongside some basic reforms of the IMF itself. In particular, China is seeking a revision of voting practices in multilateral financial institutions to bring them more in line with the growing economic power of developing nations. The Chinese economy is the second largest in the world, according to World Bank/IMF calculations; however, it ranks sixth in voting weight in the IMF (behind the United States, Japan, Germany, France and the UK).

Japanese deflation concerns build while export sector begins to stabilize

Deflationary pressures in Japan are intensifying - with negative implications for the public sector debt burden and for private sector spending prospects. The national headline consumer price index was below year-earlier levels for a fourth consecutive month in May, slipping by 1.1%, and partial data show an acceleration of this trend in June. Deflation raises the real cost of debt servicing, a particularly worrisome development in Japan where the ratio of public debt to GDP will approach 200% by the end of 2010. Moreover, deflation is a powerful disincentive to spend, as households and businesses await further rounds of price reductions, thereby delaying the economic recovery. Domestic deflation is however,

good news for exporters, particularly if they have had to cope with an appreciating currency - and the yen has gained 12% against the US dollar over the past year. Japanese exports are showing signs of stabilizing, albeit at much-reduced levels. While foreign exchange receipts in May (¥4.29 trillion) were fractionally below the previous month's level, they were still up 2.3% from the first quarter average. Nevertheless, when compared with a year earlier, they were down a punishing 40.9%, though even that shocking result represents a four percentage point improvement from the average declines over the first four months of the year. The pronounced weakness in domestic demand has resulted in even weaker performances on the import side with the result that the trade account registered a surplus of ¥222 billion in May, the largest in a year.

Hong Kong Monetary Authority follows lead of US Federal Reserve

The Hong Kong Monetary Authority (HKMA) continues to track the US Federal Reserve's interest rate initiatives as part of its commitment to maintaining the Hong Kong dollar's (HKD) peg to the US dollar (USD). Thus, the HKMA this week left its benchmark rate unchanged at 0.5% following the Fed's decision to maintain the target range for the Fed funds rate at 0-¼%. In reality, the repeated interventions by the HKMA (including HKD6.6 billion on June 25th-26th) to prevent the HKD from breaking below the 7.75 per USD threshold suggests that the monetary authorities had scope to nudge Hong Kong's benchmark interest rate even closer to the Fed funds rate. Inflationary pressures in Hong Kong are non-existent, at least for the moment. The headline consumer price index in June was unchanged from the year-earlier level in May. Reduced energy and food prices, lower government-controlled utility fees and an easing in housing costs are among the factors that have brought inflation to a halt. Sluggish spending is also a constraining element; the rise in joblessness is weighing on household incomes - indeed, average wages in March were down almost 1% y/y. Moreover, the marked weakening in tourism - the number of visitors plunged more than 13% y/y in May - may also be triggering some discounting as retailers seek to deal with excessive inventories.

Interest rates in Taiwan on hold as labour conditions begin to stabilize

Taiwan's central bank remains cautiously optimistic that an economic turning point is near, as it opted to leave its benchmark interest rate unchanged at a record-low 1.25% following this week's policy meeting; however, the possibility of further easing cannot be fully dismissed. The absence of inflationary pressures - the headline consumer price index has been hovering below year-earlier levels in recent months - gives the monetary authorities

leeway to lower interest rates, if required, and ongoing weakness in private sector borrowing - which fell 1.8% y/y in May - does not suggest an excessively accommodative monetary policy stance. Nevertheless, the leading index gained ground for a fourth consecutive month in May and labour market conditions are beginning to stabilize, although the jobless rate rose for a ninth consecutive month in May to a record-high 5.84%. Downsizing in the hard-pressed manufacturing sector has contributed to the run-up in joblessness. Sectoral output in May was down 18½% y/y. Nevertheless, industrial activity is showing signs of bottoming out alongside some considerable improvement in export orders, and the recovery has been sufficient to trigger modest increases in employment (on a month-to-month basis) in April and again in May. However, until there are more substantial improvements to employment prospects, a sustainable economic recovery will remain out of reach. We anticipate a 6% drop in GDP this year, followed by 3% growth in 2010.

New Zealand still mired in recession; some glimmers of hope

The New Zealand economy is still mired in recession, although the outlook is beginning to improve. Output declined 1.0% in the first quarter of 2009, the fifth consecutive quarterly contraction. There were, however, some glimmers of good news in the national accounts data. Exports (goods and services) increased 0.6% q/q, following two successive quarters of 3% declines; moreover, the housing component contracted by a mere 0.3%, a significant improvement in comparison with the cumulative 31% drop over the previous four quarters. While household outlays dropped 1.4% q/q - the biggest decline in the current recessionary cycle - the spending outlook may be brightening, as a recently-released survey indicates that consumer sentiment is beginning to recover. Widespread weakness in domestic spending - business investment fell 7.3% in the quarter - and a further contraction in inventories resulted in an 8.6% drop in import volumes (goods and services). The sharp contrast in export and import performances was reflected in the marked improvement in the current account of the balance of payments: the first quarter deficit shrank to a 5-year low of NZ\$1.25 billion. This is particularly encouraging, as New Zealand's external accounts have been the weak link in the nation's overall economic performance. However, the recent rebound in the value of the New Zealand dollar to US\$0.645, an appreciation of more than 30% in less than four months, puts at risk some of these hard-won gains. Even the prime minister has expressed concerns regarding the impact of recent appreciation, a trend that we expect to persist through 2010 as risk aversion gradually abates among global portfolio managers.

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