February 5, 2010

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Asia/Oceania Weekly Outlook

- **Temporary pause in Australia's monetary tightening cycle**
- **Korean and Indonesian exports surge; inflationary pressures building across the region**
- **India's trade deficit widens; no implications for monetary policy**

Temporary pause in Australia's monetary tightening cycle

The Reserve Bank of Australia's (RBA) monetary policy tightening bias remains in place. Nevertheless, the central bank surprised the markets (and us) by opting to leave its benchmark interest rate unchanged at 3.75% following the February 2nd board meeting despite recent data showing a sharp acceleration in house prices through year-end. In announcing the decision, Governor Glenn Stevens noted that there was still only "limited" information about the impact of previous rate increases (though data for the post-October period have been generally positive), providing some basis for a pause, but that further adjustments would likely be required "if economic conditions evolve broadly as expected" (the governor's complete statement can be found on the central bank's website: http://www.rba.gov.au/). The RBA remains upbeat regarding the economic outlook, anticipating an acceleration in economic activity through 2010 even as interest rates move higher, but appears equally confident that monetary tightening will prove successful in containing inflationary pressures, with the headline inflation rate slipping back from 3.0% y/y in mid-year to 2.5% by the fourth quarter (the mid-point of the official inflation target). Since the rate announcement, the Australian dollar (AUD) has weakened by more than 3% to US$0.863. We believe that the AUD setback will prove temporary and that rising interest rates together with elevated commodity prices will support renewed currency gains, eventually taking the exchange rate to parity with the US dollar.

The strength in labour market conditions in Australia suggests that the 0.7% m/m drop in retail sales in December is merely a temporary retrenchment; more representative of the underlying trend is the 1.1% q/q increase in sales in the final quarter of 2009. Rising interest rates will restrain but will not reverse the positive momentum in consumer spending. As for the corporate sector, while business confidence appears to have been shaken somewhat by the RBA's fourth quarter tightening, Australia's current commodity boom is far from over and this should provide a firm underpinning for business investment over the next several years. The combination of a strong Australian dollar and robust demand for capital and consumer goods will continue to put pressure on the import bill, limiting the prospect for significant narrowing of the trade deficit in 2010-11. The December shortfall (goods and services) totalled A$2.25 billion, as a 3.5% m/m increase in exports to A$19.8 billion was more than offset by a 7.1% jump in imports; the deficit for the fourth quarter amounted to A$6.1billion, compared with a year-earlier surplus of A$2.8 billion.

Korean and Indonesian exports surge; inflationary pressures building across the region

Two basic trends are evident across developing Asia: a recovery in exports from the depressed levels of a year ago and a food-led (but broadening) pickup in consumer price inflation. Korea and Indonesia are no exceptions to these developments. In **Korea**, exports were up 47% y/y (though the strong seasonal pattern of Korean trade left the January figure of US$31.1 billion almost US$10 billion below the record peak of July 2008), while the headline annual consumer price inflation rate broke through the 3.0% threshold for the first time since April 2008. In contrast, core inflation has been gradually easing and has slipped to a 3-year low of 2.1% y/y. The Bank of Korea (BoK) has held its benchmark interest rate at 2.0% for the past year, and in view of the conflicting inflation data and the appreciating bias of the Korean won, we believe that the BoK is not yet prepared to tighten. Although Governor Lee has occasionally warned about the eventual need for higher interest rates, we do not expect an early rate adjustment in view of the BoK's admitted uncertainties regarding the durability of the expansion. Moreover, as we have noted previously, the governor's term expires in March, and the government, which has been encouraging the monetary authorities to keep interest rates low, may be inclined to appoint a successor who is sympathetic to this approach.

Indonesia's export sector is also now fully engaged in the region-wide recovery. Foreign sales were up above year-earlier levels for a third consecutive month in December, jumping 50% from the depressed levels of end-2008. Imports are lagging; the 33% y/y December advance to US$10.3 billion represented the first annual gain in more than a year. The US$3.0 billion trade surplus was triple the year-earlier level. While economic prospects are brightening alongside the pickup in exports, the Bank of Indonesia (BI) is in no hurry to tighten monetary policy. Inflation is on the rise - the consumer price index rose 3.7% y/y in January (0.8% m/m), the biggest advance since mid-2009 - but for the moment is still below the lower end of the target range of 5%±1% and is almost 3 percentage points below BI's current benchmark rate of 6.5%. In announcing the February 4th decision to leave the rate unchanged, BI gave a generally upbeat assessment of economic conditions, while expressing confidence that "inflationary pressure will remain muted at least during the first half of 2010" and that "for 2010 as a whole, inflation is firmly on course with the target set at 5%±1%" (the complete statement can be found at the central bank's website: http://www.bi.go.id/web/en). The overall tone of the remarks suggests that the monetary authorities are still quite comfortable with the current policy; while the period of easing is likely at an end, an early bump-up in interest rates appears unlikely.

Rising energy and food prices are reflected in increasing inflationary pressures in **Thailand**. The consumer price index rose by 4.1% y/y in January, the highest increase in sixteen months; the Bank of Thailand (BoT) assesses that inflation may reach 5% y/y this year. Nevertheless, price pressures are still benign when food and energy costs are excluded; the core inflation rate was 0.6% y/y in January, hovering near the lower end of the BoT's 0.5-3.0% target range and indicating that authorities are in no rush to tighten monetary conditions. The benchmark interest rate has been kept unchanged at 1.25% since April 2009. In the **Philippines**, the inflationary impact of the harsh weather conditions last fall is beginning to abate. After accelerating rapidly from 0.7% y/y in September 2009 to 4.4% in December, consumer price inflation eased slightly to 4.3% y/y in January, thereby remaining near the midpoint of the central bank's inflation target of 4.5% ±1.0%. Price pressures on food, which accounts for close to half of the consumer price index, eased to 4.5% y/y from 5.3% the month before. Following the January 28th meeting, the Philippine central bank kept the benchmark overnight borrowing rate unchanged at 4.0%; we expect the authorities to maintain a neutral policy stance in the next few months before starting to tighten monetary conditions gradually. The Philippine economy grew by 0.9% q/q in the final three months of 2009, a third consecutive quarterly expansion; output increased by the same magnitude - 0.9% - in 2009 as a whole.

India's trade deficit widens; no implications for monetary policy

Higher oil prices, a solid pace of consumer spending and business investment and rupee appreciation (in inflation-adjusted terms) are sparking a fresh resurgence in imports into India, triggering renewed widening of the trade deficit. The shortfall exceeded US$10 billion for the first time in thirteen months in December as a recovery in exports to a15-month high of US$14.6 billion was more than offset by a surge in imports (+27% y/y) to US$24.8 billion. Buoyed by exports and by the strength in domestic spending, manufacturing activity is staging a strong rebound. Official data showed a 12.7% y/y jump in output in November, and the monthly survey of purchasing managers within the sector indicates that the momentum was sustained through January, pointing to further gains in both exports and imports. The Reserve Bank of India (RBI) is not focused on the size of the trade deficit, which is on track to exceed US$100 billion for a third consecutive year in the fiscal year ending March 2010; workers' remittances, business service income and tourism help to offset that gap. Thus, the pace of monetary policy tightening in 2010 will be determined by domestic considerations, rather than by balance of payments or exchange rate concerns. Basic food costs are rising at an annual rate of more than 15%; although food prices are not interest rate-sensitive, the RBI is undoubtedly becoming increasingly concerned about the risk of a significant buildup in inflation expectations, and hence may see the need for more aggressive preemptive action. As a result, the central bank may feel obliged to announce an increase in its benchmark interest rates (along with another bump-up in reserve requirements) before its April quarterly policy meeting.

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