



HSBC Emerging Markets Index

Q1 2011

HSBC 

The world's local bank

Stephen King

Emerging Markets: Growth outlook clouded by uncertain impact of policies to check inflation

07 April 2011

Emerging nations apply Quantitative Tightening to counter Pandora's Box of economic distortions

It is one of those moments when policymakers have to take a deep breath and hope that their policy decisions are beginning to have the desired effect. The latest HSBC Emerging Markets Index reveals that inflation is in danger of becoming an entrenched problem. Meanwhile, the pace of expansion across manufacturing and services, although perfectly adequate, has lost momentum compared with performance in earlier quarters.

Rising inflation and fading growth are hardly an encouraging combination. The hope must be that the loss of growth momentum will eventually bring inflation back down. Much, though, depends on the reasons behind the current increase in inflationary pressures.

Is inflation "externally determined," the result of rapid increases in food and energy costs beyond the control of any one country? Or, instead, are rapid increases in food and energy prices a consequence of the emerging world's failure to tighten monetary policy sufficiently in the past?

Certainly, it's difficult to explain the dramatic increase in commodity prices via economic developments in the Western world. Levels of economic activity on the two sides of the North Atlantic are either not much higher or, in many cases, still quite a lot lower than they were in 2008, suggesting that the US and Europe have played no direct part in driving commodity prices higher.

Putting to one side the political upheavals in the Middle East and North Africa, there are two key reasons why commodity prices have risen so far, so fast.

The first is the increasing structural tilt in global growth towards the emerging world. China may only be one-third the size of the US, but it is growing three times faster and its contribution to global capital spending growth is now much higher than America's. China and other emerging nations, however, are still relatively poor countries and their growth is much more commodity-intensive than the West's: the infrastructure taken for granted in the US and Europe has yet to be built in parts of the emerging world.

The second is the unintended impact of the West's unconventional monetary policies, the "money printing" designed to stimulate economic activity in the US and Europe even as interest rates approached the zero lower bound. With many emerging nations linking their currencies to the US dollar, the impact of looser policy from the Federal Reserve quickly leaked out to other parts



of the world which, unlike the US, were not heavily affected by the financial crisis. While the US and Europe struggled to recover, the emerging nations boomed and, as they did so, demand for commodities went through the roof.

Little can be done about the structural changes taking place in the global economy. Unless and until there is an increase in the supply of raw materials – for energy, now more difficult following the sudden loss of enthusiasm for nuclear power following the Japanese tsunami – it's likely that ongoing demand from the new economic superpowers will push commodity prices higher on a structural basis.

There has, however, been a conscious effort throughout the emerging world to tighten monetary policy. Although interest rates haven't risen very far – largely reflecting a desire to avoid excessive currency appreciation – emerging nations are, nevertheless, fully aware of the need to bring inflation back under control. To do so, policymakers are pursuing the polar-opposite of the quantitative easing policies in the US and Europe. They're pursuing what we at HSBC have termed "quantitative tightening".

And it's for this reason that policymakers are taking a deep breath. Quantitative tightening takes us to the outer reaches of macroeconomic experimentation. We simply do not know how to calibrate its various effects. Yet there can be no doubt that policymakers are increasingly relying upon "QT" to bring inflation under control.

While QT comes in many forms, one of the most popular is proving to be raising banks' reserve ratios. By doing so, credit growth is restrained, even if interest rates don't rise. Central banks all over the emerging world have pursued this approach with varying degrees of enthusiasm. China, perhaps the most aggressive, has raised its reserve ratio on nine separate occasions since the beginning of 2010. And while worries over rising Chinese inflation have yet to dissipate, the impact of higher reserve ratios can already be clearly seen through money supply growth, dropping from around 30% y-o-y to 15% y-o-y over the last 15 months.

If QT works and, as a result, the pace of emerging market growth continues to fade, commodity prices may eventually stabilise and perhaps even fall. This would provide huge benefits to emerging nations, not least by alleviating social and political pressures stemming from the inevitable rise in income inequality that stems from persistent gains in food and energy prices.

While it would be naive to suggest that uprisings in the Middle East and North Africa are only, or mainly, the result of rising food prices, there can be no doubt that a growing gap between "haves" and "have-nots" can ferment political instability.

Certainly, our latest forecasts are consistent with the idea that QT will constrain activity. We expect GDP growth in the emerging world to moderate to 6.3% this year after a 7.5% outcome in 2010.

Whether this will be sufficient to place a lid on commodity price inflation is debatable but there can be no doubt that the emerging nations need to find ways of controlling inflationary pressures. Unfortunately, it now appears that the West's bid to kick-start the global economy through experimental monetary stimulus has opened a Pandora's Box of economic distortions, creating a series of unexpected policy challenges for emerging nations which, unlike their cousins in the developed world, chose not to get heavily in debt in the first place.

Stephen King

Group Chief Economist

HSBC Emerging Markets Index

Emerging market growth stays firm in Q1, while cost inflation soars to highest since Q2 2008.

Key findings:

- Slight moderation in emerging market output growth.
- Capacity pressures grow, as backlogs of work rise at fastest rate for a year.
- Both input cost and output charge inflation hit near three-year highs.
- Service sector optimism remains muted by historic standards.

Emerging market growth steadies in Q1

The HSBC Emerging Markets Index (EMI), a quarterly indicator derived from the PMI surveys, showed that emerging market growth eased slightly in the first quarter of 2011. The index dipped from a figure of 55.7 to 55.0, but was broadly in line with the long-run series average of 54.9.

The EMI is based on 21 PMI (Purchasing Managers' Index) surveys conducted across 16 emerging markets and provides the earliest and most reliable indication of economic trends.

The slight moderation in emerging market growth reflected slower expansions in services and manufacturing, with growth in the former hitting a near two-year low. Manufacturers recorded a faster rate of expansion than service providers for the second quarter in succession.

Eastern Europe records strong growth in manufacturing

Factories across Eastern Europe remained a hive of activity in the first quarter, with production growth hitting series-record highs in the Czech Republic and Turkey (the latter for a second successive quarter). Russia saw manufacturing output rise at the strongest rate in three years, while growth in Poland was also stronger than that seen at the emerging market average.

Divergent trends were recorded across emerging Asia in Q1 2011. Output growth held steady at a near-record rate in India, while Taiwan and South Korea manufacturers saw a strong rebound in activity, with the upturn in the former particularly pronounced. In contrast, Singapore saw only a slight expansion in output, and growth eased markedly in China.

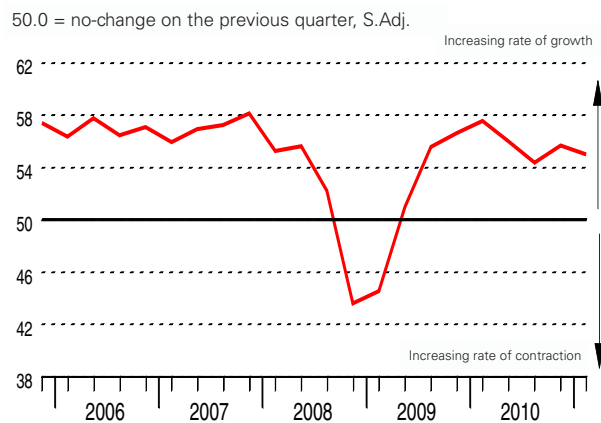
Growth of manufacturing production was supported by a continued expansion of new export business, which increased at the fastest rate in three quarters during Q1. However, the rate of expansion was much weaker than that seen one year earlier. The Czech Republic, India, Poland, Turkey and Taiwan all recorded steep increases in new export orders, while growth was solid in Hong Kong, Saudi Arabia and South Korea. In contrast, growth was only slight in Brazil and China.

Service sector growth in China falls to record low

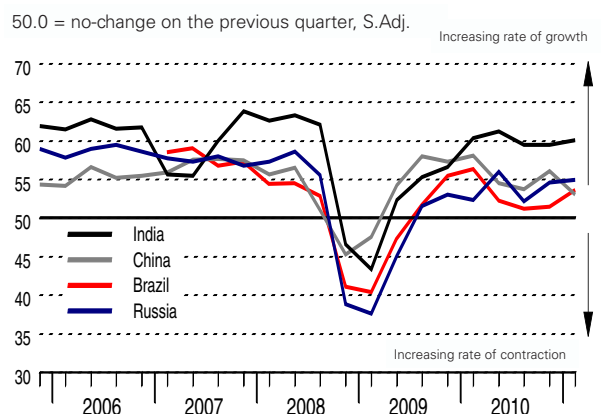
Service sector activity grew at a sub-par rate in Q1, with growth easing to a seven-quarter low. This reflected slower expansions in China and Russia, with the former registering the weakest increase in business activity since the start of the series in Q4 2005. Brazil recorded a moderate expansion, while India again led the pack, with growth the highest in three quarters.

Emerging market service providers remain confident about the one-year business outlook, although the degree of optimism

EMI (all-sector output)



BRIC (all-sector output)



was muted in the context of historical data. Positive sentiment in the Indian service sector was the highest for three years, while Russian business optimism was broadly in line with the long-run trend. In contrast, Business Expectations indexes for Brazil and China were around eight index points lower than their respective long-run trends.

Input cost inflation accelerates

Input cost inflation across the emerging world quickened to the strongest since Q2 2008, with manufacturers again recording a much faster increase in cost burdens than their service sector counterparts. Cost inflation in services quickened to a two-and-a-half year high in the first quarter, with the rise in the relevant index among the largest in the series history. Meanwhile, manufacturing firms recorded the third-fastest rise in the average cost of their purchases since the start of the series in Q2 2004.

Supply chain bottlenecks persist

The stronger rate of inflation signalled by the EMI findings reflects rising raw material, food and energy costs. Many commodity prices such as copper hit record highs in Q1, while unrest in the Middle East sent the price of crude oil to new heights. Rising cost pressures also reflect the growing imbalance between the supply of, and demand for, raw materials. Growing demand for inputs at the world's factories has led to shortages of many goods, with emerging market manufacturers reporting a further deterioration in average vendor performance during Q1, extending the current period of longer lead times to seven quarters.

Charge inflation continued to move higher

The passing on of higher costs to clients through increased output charges continued in Q1 2011, with the rate of inflation quickening to a near three-year high. As was the case for input prices, output charge inflation in the manufacturing industry eased slightly, but remained much stronger than that seen in the service sector, where charge inflation quicken to the sharpest in eleven quarters.

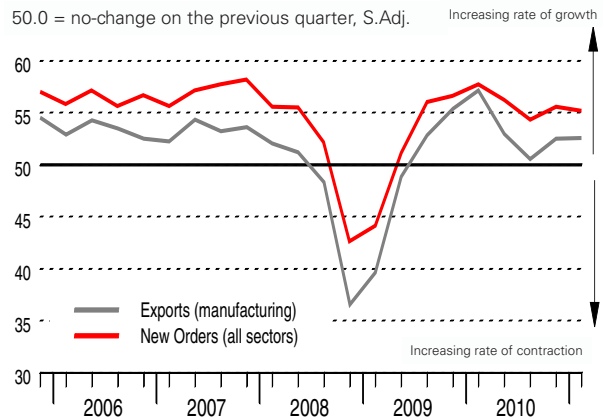
Of the big-four emerging markets, Russia recorded the strongest rise in output prices. Charge inflation accelerated to a ten-quarter high in India, led by a series record rise in manufacturing, while China saw a marked cooling of inflation. Despite quickening to the fastest for a year, the rate of output price inflation was relatively modest in Brazil.

Job creation continues, as capacity pressures build

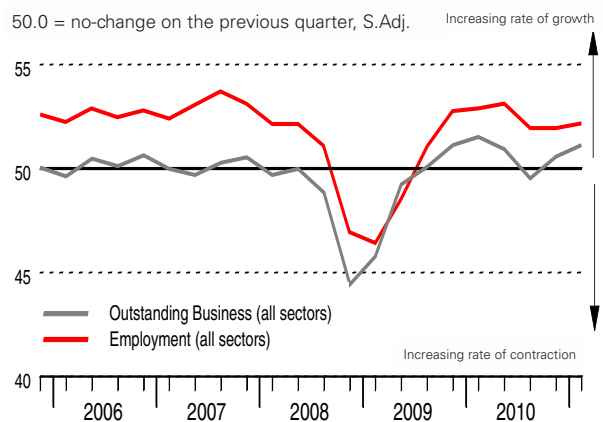
Emerging market firms continued to add to their staff numbers on average in Q1, with the pace of job creation broadly similar to that seen throughout H2 2010.

Growing capacity pressures across the emerging world, as signalled by a near record increase in outstanding business during Q1, will likely prompt firms to hire additional staff over the coming quarter. The accumulation of backlogs was centred on the manufacturing sector, where growth reached a three-quarter high, as service providers saw no-change in work-in-hand over the quarter.

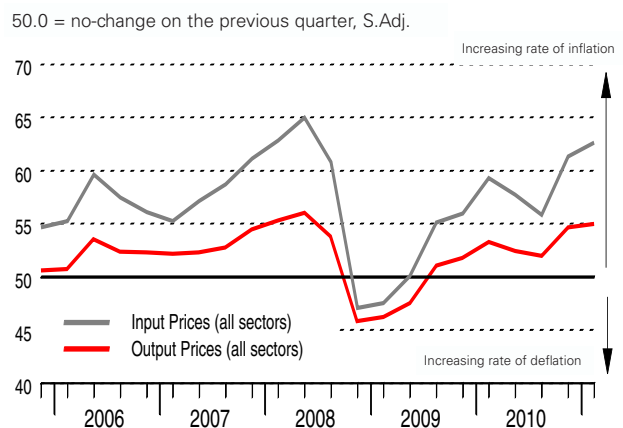
Orders and exports



Employment and backlogs of work



Input and output prices



Output

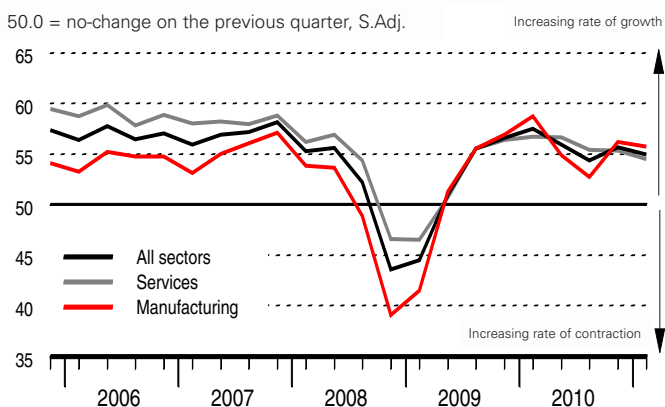
Marked increase in emerging market output recorded in Q1.

Emerging market output rose markedly in the first quarter of 2011. Nonetheless, the rate of growth was the second-slowest in seven quarters.

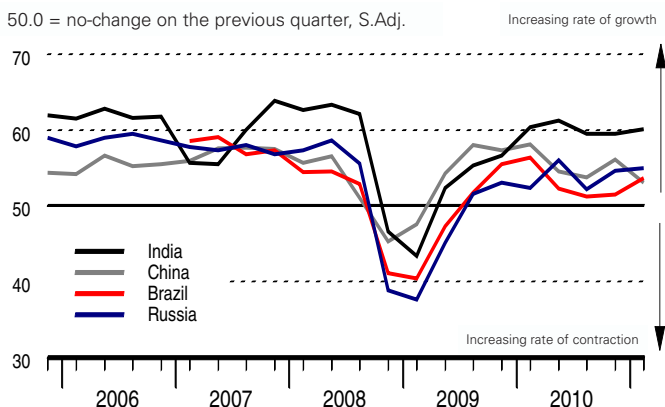
The moderation was principally led by the service sector, where activity growth eased to the weakest since Q2 2009. A slower expansion of manufacturing production was also recorded in Q1. However, in contrast to services, the pace of growth in manufacturing was faster than the long-run trend.

Of the largest emerging markets, India recorded by far the strongest growth, with expansion reaching a three-quarter high. China, meanwhile, saw growth ease to the slowest in the current eight-quarter period of expansion. Growth hit four- and three-quarter peaks in Brazil and Russia respectively.

Output by sector



Output in BRIC countries (all sectors)



New Business

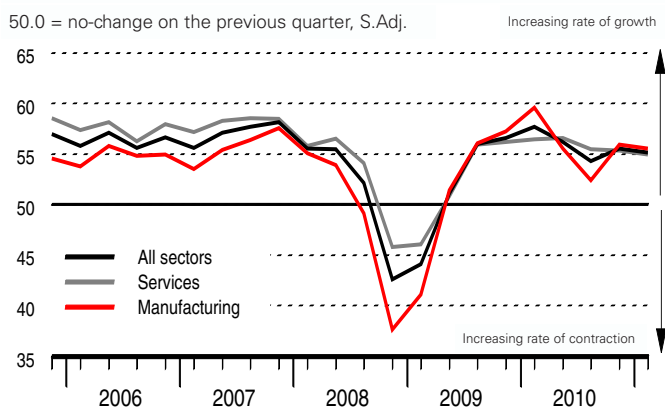
New business rose markedly in Q1, with India the key contributor to growth.

The level of incoming new business rose for an eighth successive quarter in Q1, although the rate of expansion eased to the second-slowest since Q2 2009.

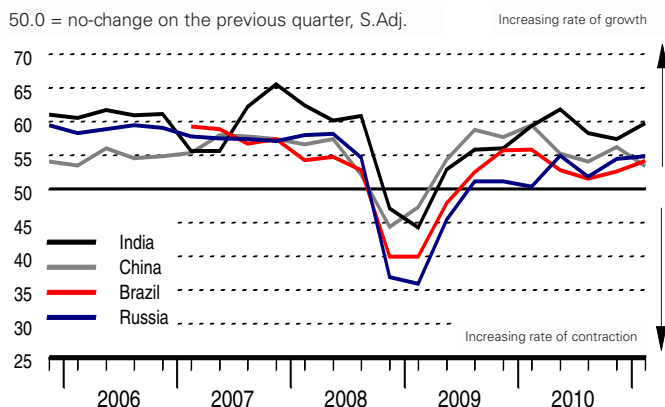
Rates of new order growth eased fractionally across both manufacturing and service sectors, with the overall expansion in the former remaining stronger than the latter. Growth of new orders in manufacturing was faster than the lull seen in Q3 2010, but still down on the record high registered one year ago. Meanwhile, service sector new business rose at the slowest rate for seven quarters.

India was the key driver of new business growth in Q1, with overall expansion the sharpest in three quarters. In contrast, China saw new order growth cool to an eight-quarter low.

New business by sector



New business in BRIC countries (all sectors)



Outstanding Business

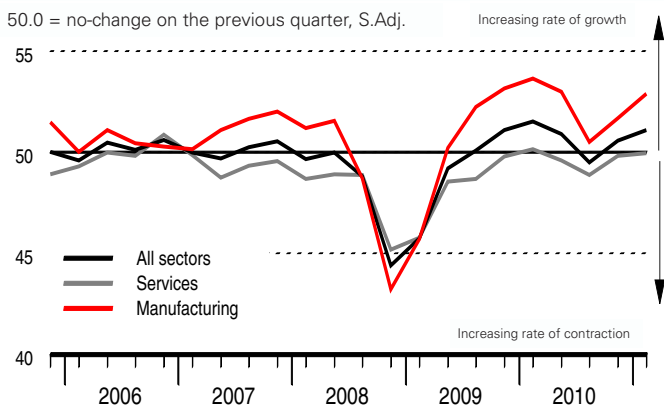
Outstanding business rose at a near-record rate in Q1.

Backlogs of work across the emerging world increased for a second successive quarter in Q1, with the pace of accumulation quickening to the joint second-fastest since the start of the series in Q4 2005.

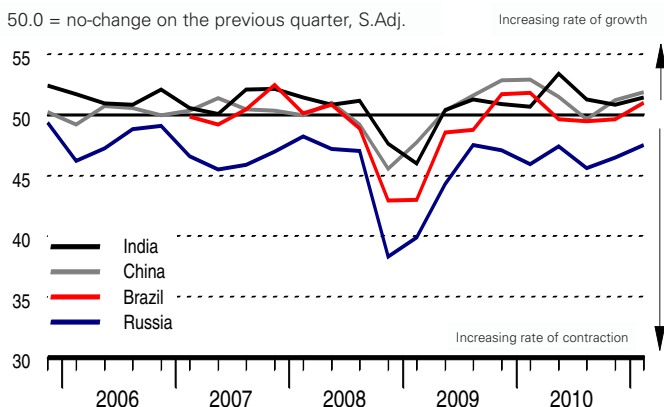
The overall expansion was centred on the manufacturing sector, which saw the sharpest rate of backlog accumulation for three quarters. In contrast, volumes of unfinished business were unchanged in the service sector.

Of the big-four emerging markets, Russia was the only one to post a reduction in outstanding business in Q1. Renewed growth of outstanding business was indicated in Brazil, while China and India recorded accelerations in growth to four- and three-quarter highs respectively.

Outstanding business by sector



Outstanding business in BRIC countries (all sectors)



Employment

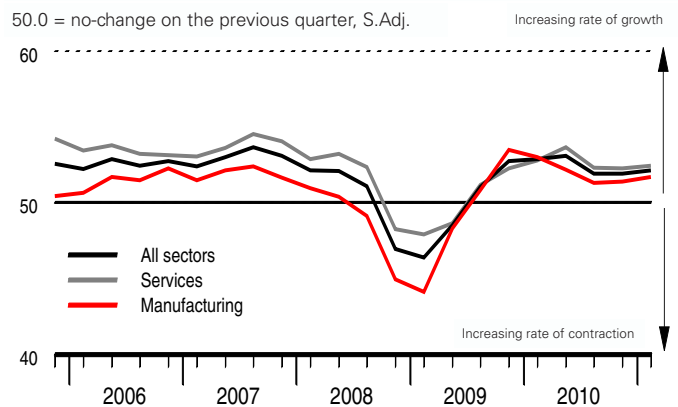
Growth of emerging market employment improved slightly in Q1.

Employment in emerging markets rose again during Q1, extending the current period of growth to seven quarters. The rate of job creation quickened slightly since Q4 2010, and was stronger than the long-run trend.

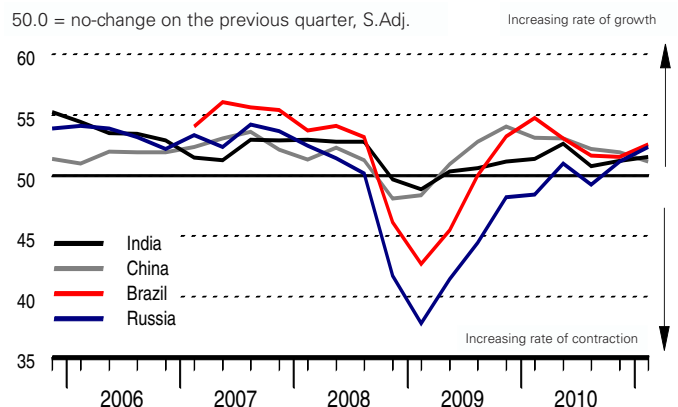
Service providers continued to raise their staff numbers to a greater extent than manufacturers. In both sectors, rates of growth quickened to three-quarter highs, but remained slower than one year ago.

Rates of job creation accelerated across three of the big-four emerging markets, with China the exception. Here, growth slowed to a seven-quarter low. In India, workforce expansion was centred on the service sector, while Russia saw the sharpest rate of job creation in three years.

Employment by sector



Employment in BRIC countries (all sectors)



Input Prices

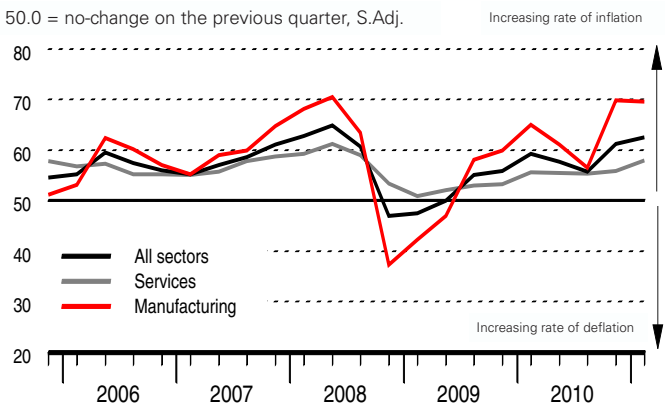
Cost inflation quickened to the sharpest since Q2 2008.

Average cost burdens faced by emerging market companies rose substantially in Q1, with the rate of inflation quickening to the strongest in almost three years.

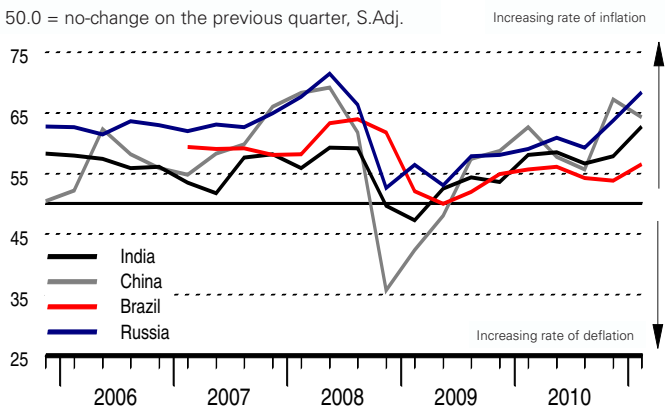
The pace of purchase price inflation in the manufacturing sector was broadly unchanged on the previous quarter's two-and-a-half year high. Meanwhile, service providers reported the sharpest increase in average input costs for two-and-a-half years, with the rise in the relevant index among the largest in the series history.

Cost inflation quickened across three of the big-four emerging markets, with China the only exception. A series record increase was recorded in India, while Brazil and Russia saw inflation hit nine- and eleven-quarter highs respectively.

Input prices by sector



Input prices in BRIC countries (all sectors)



Output Prices

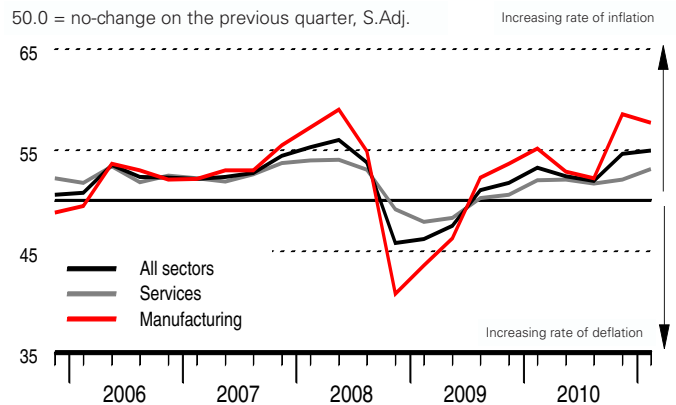
Output price inflation hit a near three-year high in Q1.

The rate of output price inflation accelerated to the sharpest in almost three years during Q1 2011, as firms passed on rapidly rising input costs to clients through increased charges.

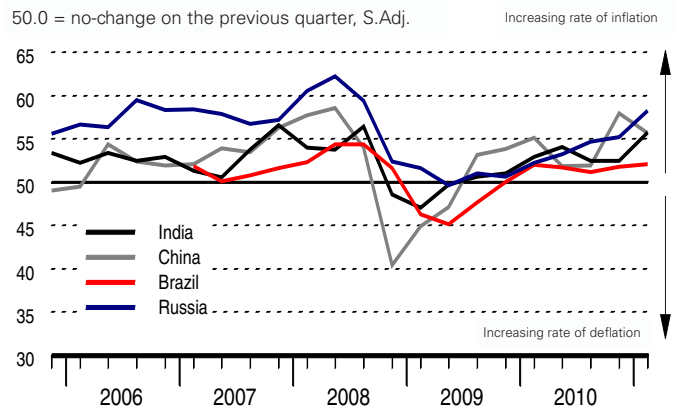
Manufacturers again raised their output prices at a sharper rate than service providers, reflecting their greater exposure to global price pressures, with inflation running at the third-highest pace in the series history. In the service sector, the rate of charge inflation also accelerated, reaching its strongest for almost three years.

Of the largest emerging markets, Russia recorded the steepest rate of charge inflation. India saw output prices rise at the fastest rate for two-and-a-half years, while inflation cooled in China. Brazil recorded only a modest increase.

Output prices by sector



Output prices in BRIC countries (all sectors)



New Export Orders

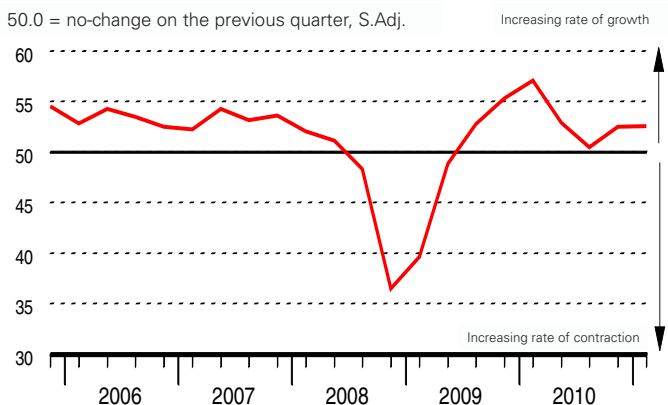
Export growth remained solid, but much slower than one year ago.

Foreign demand for emerging market manufactured goods was solid in the first quarter of 2011, supporting another rise in total new export orders. Nevertheless, growth remained much milder than a year ago, largely reflecting relatively weak performances from both China and Brazil – two of the largest emerging markets.

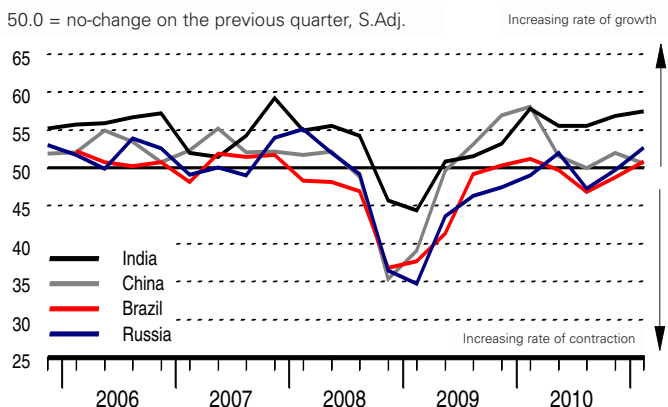
China was the only one of the big-four emerging nations to post a slower expansion of new export work in Q1. It was also the only one of the big-four in which growth was below its long-run series average.

Sharper increases in new export business were seen across ten of the emerging markets surveyed in Q1, with the most noticeable accelerations recorded in Taiwan and South Korea.

New export orders (manufacturing)



New export orders in BRIC countries (manufacturing)



Quantity of Purchases

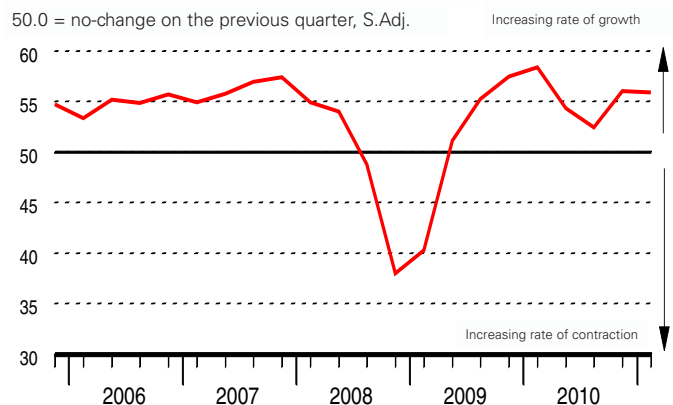
Purchasing rose markedly in Q1, with growth holding relatively steady since Q4 2010.

Purchasing activity across the emerging world increased during Q1, as it has done in every quarter since Q2 2009. The rate of expansion was little-changed from that recorded in the previous quarter and remained above the long-run trend.

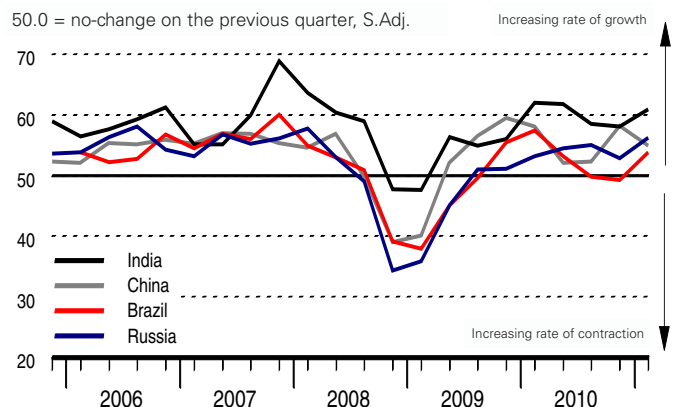
Saudi Arabia recorded the sharpest expansion of input buying, followed by India (three-quarter peak) and Turkey (all time high). Purchasing activity in Brazil and Taiwan increased for the first time in three quarters, with strong expansion in the latter contrasting sharply with a fractional decline in Q4 2010. Russia meanwhile saw growth accelerate to a three-year high.

In contrast, China saw growth of purchasing activity ease markedly in the first quarter of 2011.

Quantity of purchases (manufacturing)



Quantity of purchases in BRIC countries (manufacturing)



Stocks of Finished Goods

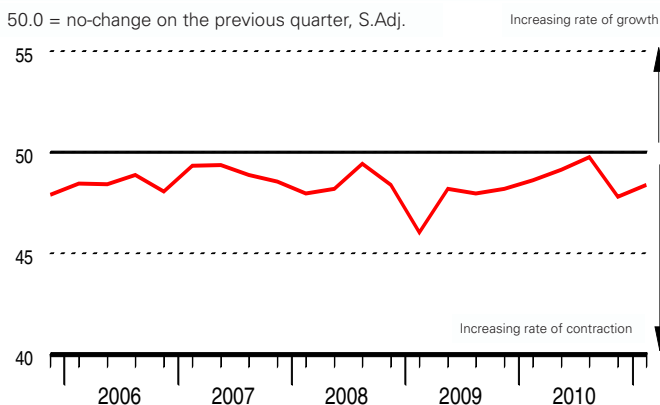
Further decline in stocks of finished goods signalled by EMI findings.

Post-production holdings at emerging world manufacturers were reduced during Q1, as has been the case throughout the series history. Although the rate of reduction moderated since Q4 2010, it remained sharper than the long-run average for the series.

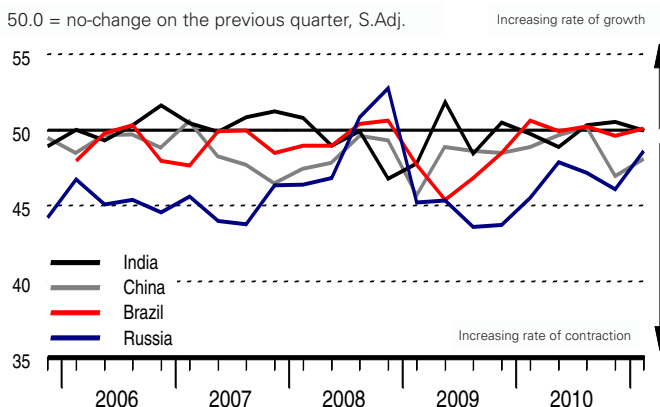
The majority of monitored emerging markets posted lower stock levels in the first quarter of 2011, but only in Poland and South Korea did the rate of decline accelerate (noticeably in the former).

Only Brazil, Singapore and Taiwan registered an increase in finished goods holdings, with the rate of expansion in the latter the fastest for thirteen quarters. Inventories were unchanged in India, and fell in China.

Stocks of finished goods (manufacturing)



Stocks of finished goods in BRIC countries (manufacturing)



Stocks of Purchases

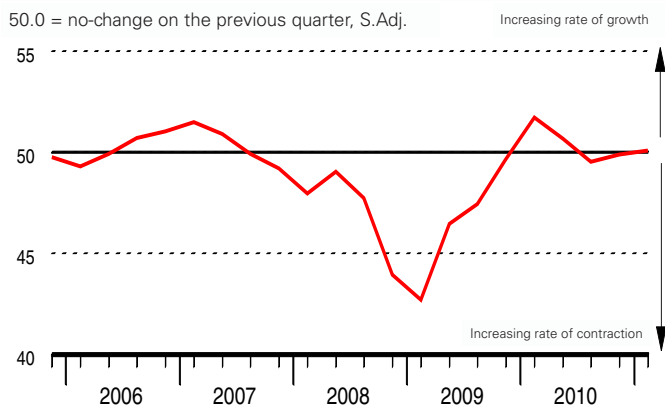
First increase in pre-production inventories since Q2 2010.

Reflecting further growth of buying activity, stocks of purchases at emerging market manufacturers accumulated during Q1, albeit only marginally. It was the first rise in inventories since Q2 2010.

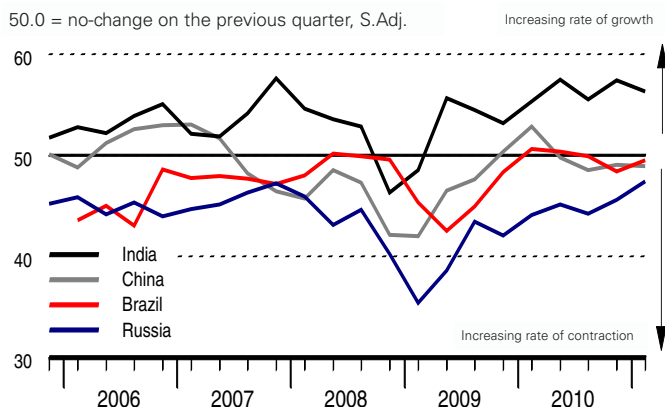
Of the sixteen markets for which inventory data are available, ten recorded higher stock holdings in Q1. Saudi Arabia registered the fastest rate of stock accumulation, followed by South Africa and India. Manufacturers in Taiwan and Turkey also saw an increase in pre-production inventories.

In contrast, Brazil and China both recorded further reductions in stocks, while Poland saw the rate of destocking accelerate since the preceding quarter. Mexico, Russia and South Korea also signalled declines in inventories over the quarter.

Stocks of purchases (manufacturing)



Stocks of purchases in BRIC countries (manufacturing)



Suppliers' Delivery Times

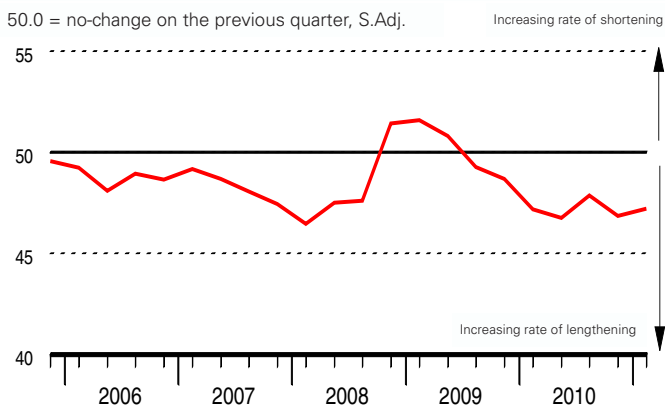
Supply chain bottlenecks persist in Q1, as demand for inputs remained strong.

Emerging market manufacturers reported longer lead times in the first quarter of 2011. Delivery delays have now been recorded for seven successive quarters, although the latest deterioration was less marked than in the final quarter of 2010.

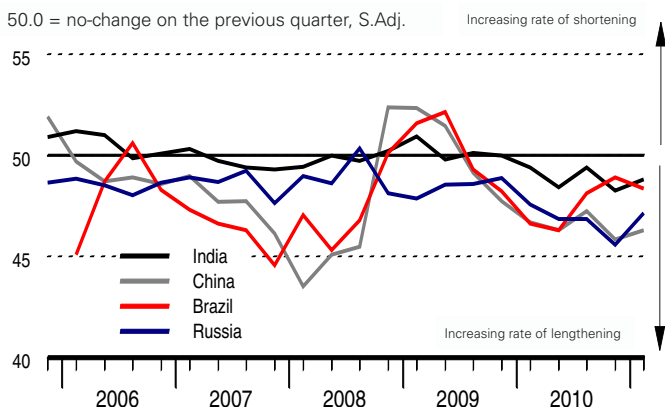
Most markets monitored by the survey registered slower delivery times in Q1, with Turkey posting a series record rate of lengthening. Only South Africa, Mexico, Saudi Arabia and the UAE registered an improvement in vendor performance. In South Africa, lead times shortened at the fastest pace since Q1 2002.

Of the largest emerging markets, Russia, India and China all recorded slower deteriorations in supplier performance.

Suppliers' delivery times (manufacturing)



Suppliers' delivery times in BRIC countries (manufacturing)



Business Expectations

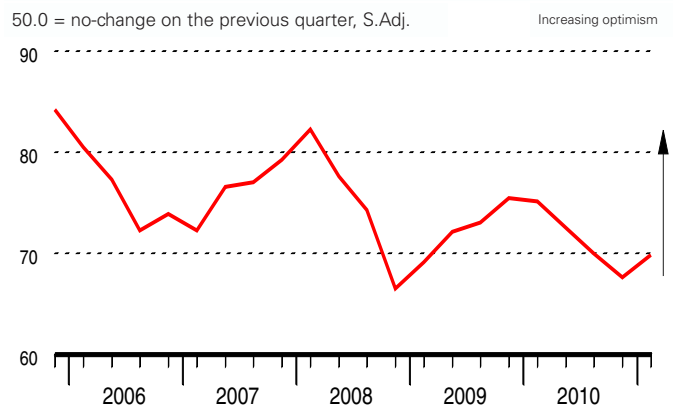
Service sector optimism weighed down by Brazil and China.

Service sector business expectations remained muted in the context of historical data in Q1, with the degree of optimism the fourth-lowest in the five-and-a-half year series history.

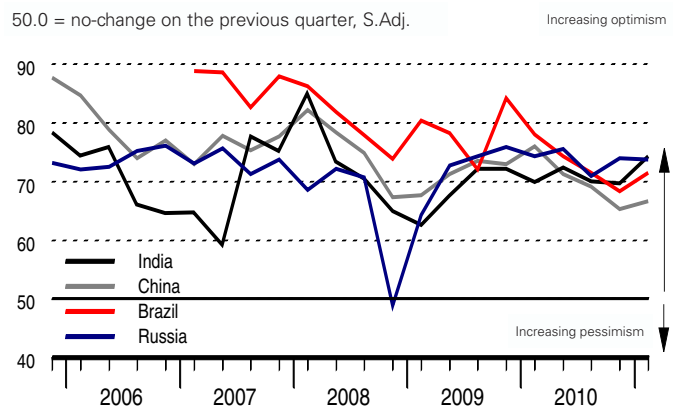
Indian service providers were the most optimistic about the one-year business outlook, with confidence at a three-year high in Q1. Meanwhile, positive sentiment in Russia was broadly in line with the long-run trend.

Brazil and China, on the other hand, saw service sector confidence remain comfortably below trend, with both Business Expectations indexes posting readings around eight index points below their respective long-run averages.

Business expectations (services)



Business expectations in BRIC countries (services)



Background Information

The Survey

The HSBC Emerging Markets Index (EMI) is a weighted composite indicator derived from national Purchasing Managers' Index™ (PMI™) surveys in the emerging markets of Czech Republic, Hong Kong, Israel, Mexico, Poland, Singapore, South Africa, South Korea, Taiwan, Turkey, UAE, Saudi Arabia and the increasingly important BRIC economies of Brazil, Russia, India and China. These surveys collectively track business conditions in over 5,800 reporting companies.

The Purchasing Managers' Index (PMI) surveys on which the EMI is based have become the most closely-watched business surveys in the world, with an unmatched reputation for accurately anticipating official data. The survey data are collected using identical methods in all countries, with survey panels stratified geographically and by International Standard Industrial Classification (ISIC) group, based on contributions to GDP.

Survey responses reflect the change, if any, in the current month compared to the previous month based on data collected mid-month. For each of the indicators, a 'diffusion' index is produced, which reflects the percentage of positive responses plus a half of those responding 'the same'. Diffusion indexes have the properties of leading indicators and are convenient summary measures showing the prevailing direction of change. An index reading above 50 indicates an overall increase in that variable, below 50 an overall decrease. All data are seasonally adjusted.

Data collected at the national level for manufacturing and services are then weighted together according to relative contributions to national or regional GDP to produce indicators at the national whole economy or aggregate emerging market level.

Data Sources

Country/ Region	Producer:
Brazil	Markit
Russia	Markit
India	Markit
China	Markit
South Korea	Markit
Taiwan	Markit
Hong Kong	Markit
South Africa	BER
Singapore	SIPMM

Israel	IPLMA
Turkey	Markit
Poland	Markit
Czech Republic	Markit
Mexico	IMEF
UAE	Markit
Saudi Arabia	Markit

HSBC

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Markit Economics is a specialist compiler of business surveys and economic indices, including the Purchasing Managers' Index (PMI) series, which is now available for 26 countries and key regions including the Eurozone and BRIC. The PMIs have become the most closely watched business surveys in the world, favoured by central banks, financial markets and business decision makers for their ability to provide up-to-date, accurate and often unique monthly indicators of economic trends.

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