



HSBC Emerging Markets Index

Q2 2011

HSBC 
The world's local bank

Stephen King

Persistent quantitative tightening contributes to dwindling inflation pressures across the emerging world.

07 July 2011

The emergence of "*The Southern Silk Road*" sets the scene for a revolution in the global economy.

With a further drop from 55.0 to 54.2 in the second quarter of 2011, the latest reading of the HSBC Emerging Markets Index (EMI) confirms that, after a strong rebound in the immediate aftermath of the global financial crisis, the pace of activity is fading. Output growth is at its weakest for two years. Much of the loss of momentum is taking place in manufacturing although the service sector is not entirely immune.

Overall, the latest readings are consistent with the impression that world trade growth peaked in the first quarter of the year and has since lost momentum. In many parts of the emerging world, there has been a noticeable reduction in the growth of export orders, consistent with the experience of countries in the developed world.

Doubtless, the second quarter readings offer greater uncertainty than usual, a reflection of the possible distortions to the global supply chain associated with the Japanese earthquake and tsunami. We will find out more in the months ahead about the extent to which Japan's terrible tragedy has led to a temporary dip – as opposed to a permanent slowdown - in economic activity around the world. Yet, even if global supply disruption is playing a part, other influences are also making themselves felt.

Of these, perhaps the most welcome – at least from a policymaker's point of view - is the impact of persistent policy tightening on inflation. Higher interest rates and a cornucopia of "quantitative tightening" (QT) measures may be leading to slower growth but they are also contributing to dwindling inflation pressures.

While many central banks in the emerging world have resisted aggressive increases in interest rates, fearing excessive currency appreciation, it seems that QT measures recently adopted in many emerging nations have put the brakes on inflation. Input price inflation has certainly faded – with the latest readings showing the sharpest easing of pressures in two-and-a-half years - and there are some initial signs that output price inflation pressures may also be on the wane. This seems particularly true of China, where both output growth and inflation have headed significantly lower during the first half of 2011.

While softer growth on its own is hardly welcome, the slowdown is proving to be a useful antidote to excessive inflation. Yet this is hardly an excuse for policymakers to relax. With persistently low interest rates in the US and elsewhere in the developed



world, emerging nations have become magnets for global capital. The risks associated with this are many: asset price bubbles, property booms, excessive currency appreciation and, of course, inflationary pressures. We shall need to see more evidence of progress on inflation later this year before being able to declare victory through the various unconventional QT options.

While the EMI provides a near-term barometer of developments throughout the emerging world, it's important not to lose sight of some of the important structural changes now taking place in the global economy. Even before the financial crisis, economic growth in the emerging world was pulling away from the developed world. Post-crisis, that trend has only been accentuated. Yet this raises an obvious question. If growth in the emerging world is export-led and ultimately dependent on demand from US and European consumers, how can the emerging nations expect to carry on growing given the ongoing weakness of the western economic recovery?

The answer, we believe, lies with what HSBC has termed "The Southern Silk Road", a new network of "South-South" trade connections slowly being established between nations in the emerging world. With some of the biggest M&A deals in Latin America last year involving Chinese companies and with ever-more Asian investment pouring into infrastructure projects elsewhere in the emerging world, the scene is set for a revolution in the global economy that will bypass both North America and Europe.

The incentives for change are enormous. China and India are both growing at an extraordinary rate: incomes per capita in China, for example, are increasing every ten years by the same amount that the US took 50 years to achieve in the 19th Century and the first half of the 20th Century.

To sustain these kinds of growth rates, China and India need guaranteed access to the world's raw materials. Yet the infrastructure needed to extract and transport these commodities from elsewhere in the emerging world is often, at best, rudimentary. As a result, we are likely to see more and more Asian-funded infrastructure projects in Latin America and parts of Africa. As this new infrastructure comes on stream, so a new network of economic connections across the emerging world will be established.

Meanwhile, the car industries developing behind closed doors in China and India are creating cars which, in time, can be sold

elsewhere in the emerging world. With incomes per capita in the emerging world now reaching levels where the purchase of a first, very cheap, car becomes a viable option, it's not difficult to imagine a new consumer revolution focusing less on the US and Europe and a lot more on demand from the emerging nations.

The result of all these changes could easily be a tenfold increase in "South-South" trade in the first half of the 21st Century, a replay of the explosion of trade that led to stronger economic connections between countries in the OECD world back in the 1950s and 1960s. "South-South" connections are the last great unexplored opportunity, carrying the potential to turbo-charge global economic growth in the years ahead even while the West remains heavily constrained by excessive debts.

Overall, then, the softness revealed within the latest EMI indicates, first, that earlier policy tightening may be working and, second, that inflationary pressures may be fading. And if a "soft landing" can be achieved, the stage is set for a sustained period of growth across the emerging world driven by new "South-South" connections.

Stephen King

Group Chief Economist

HSBC Emerging Markets Index

Emerging market output growth weakest for two years in Q2 2011. Price pressures ease sharply.

Key findings:

- New business rises at slowest rate since Q3 2010.
- Input cost inflation eases markedly.
- Longer lead times recorded for eighth successive quarter.
- Service sector business optimism remains historically weak.

Output growth eases further from Q4 2010 peak

The HSBC Emerging Markets Index (EMI), a quarterly indicator derived from the monthly *PMI*TM surveys, showed that emerging market growth continued to ease in Q2 2011. The index posted 54.2, down from 55.0 in the first quarter, and the weakest reading for two years.

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

The moderation in overall activity growth reflected a weaker increase in manufacturing production, with the pace of expansion easing to the slowest in three quarters. Meanwhile, service providers recorded a slightly faster rise in business activity, albeit one that was the second-slowest since Q2 2009.

Broad-based slowdown in manufacturing

Rates of production growth eased across the majority of manufacturing sectors monitored by the survey, with South Africa and Singapore the two exceptions. Particularly marked slowdowns were registered in Turkey and the Czech Republic, with rates of expansion down on record highs seen in the first quarter. Elsewhere in Eastern Europe, Poland and Russia saw activity growth moderate to four- and five-quarter lows respectively.

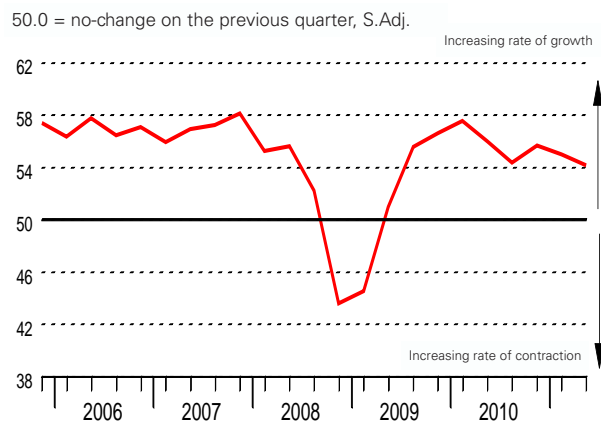
Looking at Emerging Asia, factory output rose at the weakest rates for two quarters in Taiwan and South Korea, while China saw growth slow to the least marked in nine quarters. Even India recorded a slower rise in manufacturing output, although the rate of growth remained substantial, and by far the sharpest of all emerging markets monitored by the survey.

The weaker increase in manufacturing output in part reflected a moderation in new order growth, which in turn was linked to a slowdown in the rate of expansion in new export orders to a marginal pace. Of the largest emerging markets, Brazil, China and Russia all recorded reductions in new export orders. Meanwhile, India reported the slowest pace of growth for one-and-a-half years, and rates of expansion eased noticeably in Taiwan and South Korea. Only marginal increases in exports were seen in Turkey (slowest in nine quarters) and Poland (growth at seven-quarter low).

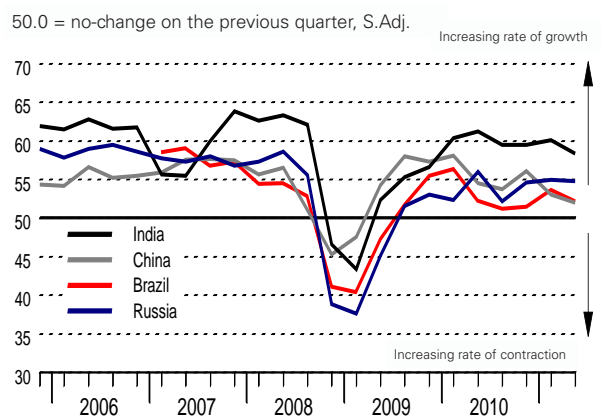
Service sector growth holds steady in Q2

Despite easing to a six-quarter low, India again recorded the fastest rate of activity growth of all emerging market service sectors monitored by the EMI, followed closely by Russia. Rates of expansion held broadly steady in Brazil and Mexico, while

EMI (all-sector output)



BRIC (all-sector output)



output growth accelerated from Q1's record low in China.

Business optimism among emerging market service providers dipped to the fourth-lowest in the series history, with confidence in China sliding to a record low. Meanwhile, Indian service providers were less optimistic about future activity levels than in Q1. Conversely, optimism in the one-year business outlook reached a six-quarter peak in Brazil, and hit a six-and-a-half year high among Russian service sector firms.

Delays in the supply chain persist

Reflective of a further moderation in output growth, the quantity of inputs acquired by emerging market manufacturers rose at the slowest rate in three quarters. Stocks of raw materials and semi-manufactured goods fell marginally in the second quarter, and at the fastest rate since Q3 2009. Manufacturing firms utilised stock holdings in an attempt to mitigate against delays in the supply chain amid widespread disruption in the wake of Japan's earthquake and tsunami.

The average time taken by vendors to deliver inputs to emerging market manufacturers lengthened for the eighth quarter running in Q2, although the rate of delivery time lengthening eased to the slowest since Q3 2010. The Czech Republic and Israel registered the most marked deteriorations in average vendor performance.

Input price inflation eases to three-quarter low

Against a backdrop of continued monetary tightening by central banks across the emerging world, the latest EMI findings signalled the sharpest easing of input cost inflation for two-and-a-half years. This was signalled by the input prices index dropping more than four points from Q1's eleven-quarter high. The moderation was centred on the manufacturing sector, where purchase price inflation eased to a three-quarter low. Service providers again recorded a slower rise in average costs than manufacturers. However, with only a modest easing of price pressures in services, latest data indicated a sharp narrowing of the inflation gap between the two sectors.

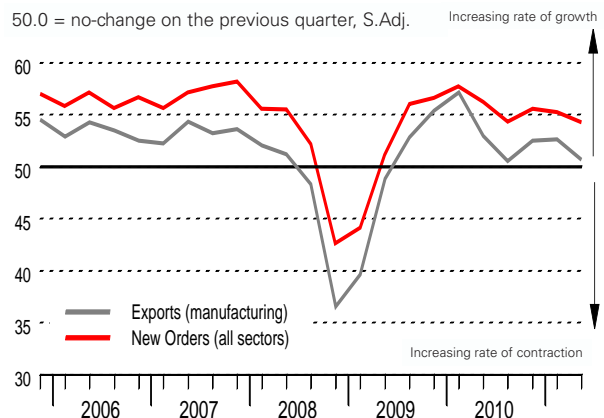
With input price inflation weaker, emerging market firms raised their output charges at the slowest rate for three quarters in Q2 2011. Similar to the trend for average costs, manufacturers recorded a sharper moderation in output price inflation than their service sector counterparts. All four of the largest emerging markets saw a slower rise in output charges as measured across both manufacturing and services.

First decline in outstanding business since Q3 2010

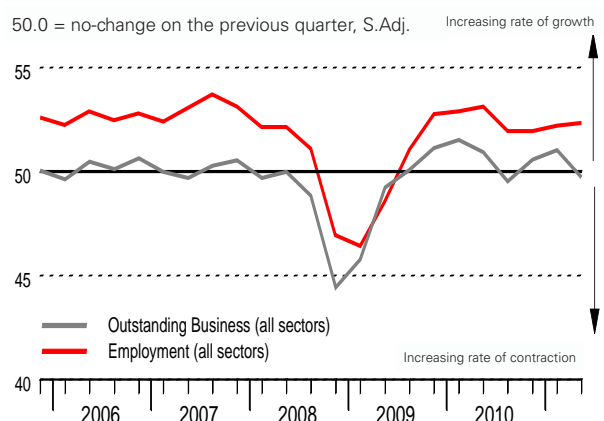
Emerging market companies continued to increase their employee numbers in Q2, with the rate of job creation reaching a four-quarter high. This occurred despite a decline in outstanding business for the first time since Q3 2010. Falling backlogs commonly indicate the development of spare capacity, which suggests that employment growth will likely slow heading into the second half of 2011.

Service providers recorded a faster increase in staff levels than manufacturers, with employment growth the fastest for a year in the former. In contrast, manufacturing firms added to their workforce numbers at the slowest rate since Q3 2009.

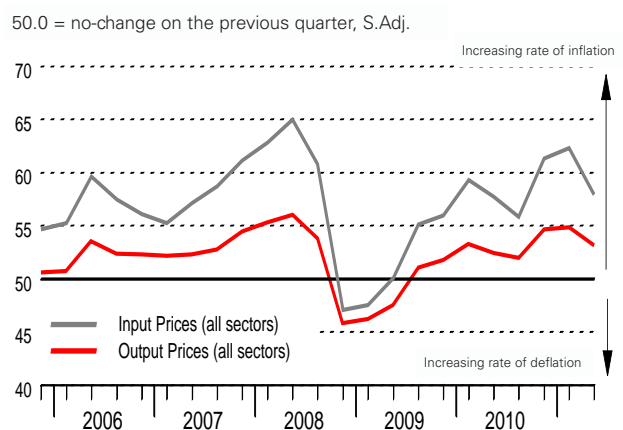
Orders and exports



Employment and backlogs of work



Input and output prices



Output

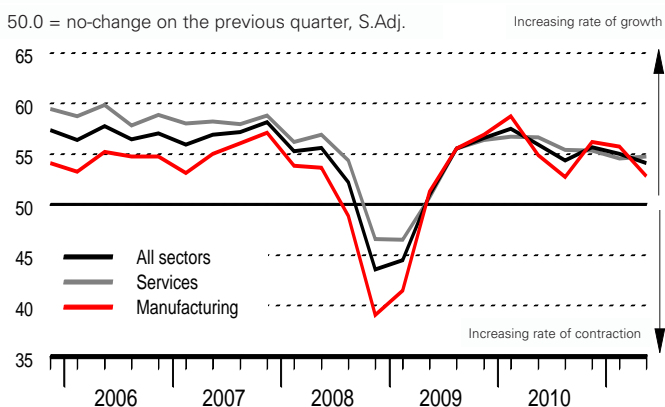
Emerging market output growth eases to two-year low, led by manufacturing.

A further rise in emerging market output was recorded during Q2. Although solid, the rate of activity growth weakened to the slowest in two years, and was below the long-run series average.

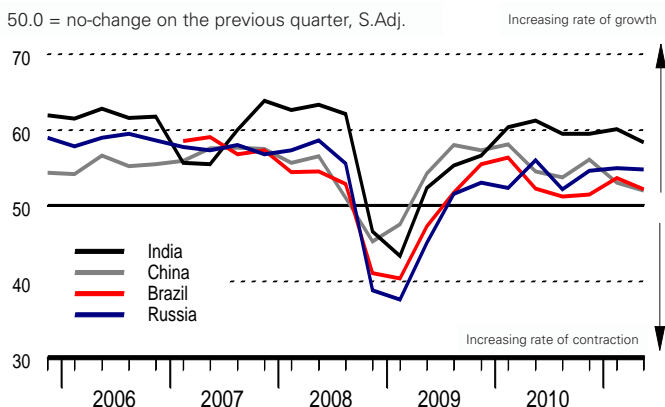
At the composite level, the moderation in output growth was centred on manufacturing, with factory production rising at the slowest rate since Q3 2010. In contrast, service providers saw activity growth quicken from Q1's seven-quarter low.

Despite easing to the slowest since Q4 2009, activity growth in India was by far the sharpest of the big-four emerging markets, followed by Russia. Meanwhile, China registered the weakest expansion of private sector activity in nine quarters, as manufacturing production growth eased to only a modest pace. A weaker rise in output was also recorded in Brazil.

Output by sector



Output in BRIC countries (all sectors)



New Business

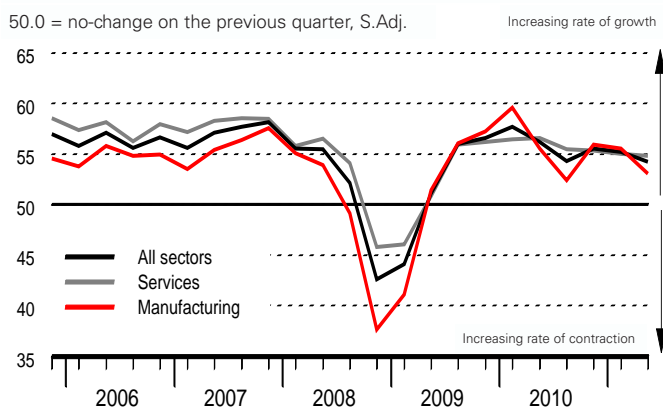
Growth of new orders loses further traction in the second quarter of 2011.

The latest EMI findings signalled that growth of demand for goods and services continued to soften in the second quarter, with new orders rising at the slowest rate since Q3 2010.

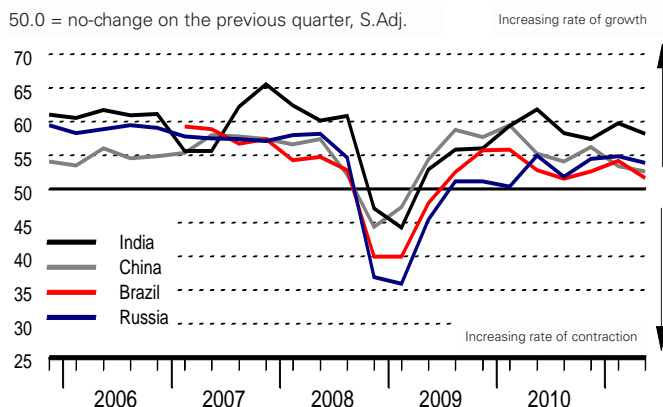
Both manufacturers and service providers recorded slower rates of new business growth in Q2 2011, easing to three- and eight-quarter lows respectively.

India was again the principal driver of new order growth as measured across both manufacturing and services, although the rate of expansion was slower than in Q1. Similarly, both Brazil and Russia saw growth rates ease to three quarter lows, while China recorded the slowest rise in new order intakes for nine quarters. Most emerging market manufacturers saw a moderation in new order growth, with Turkey reporting a particularly marked slowdown.

New business by sector



New business in BRIC countries (all sectors)



Outstanding Business

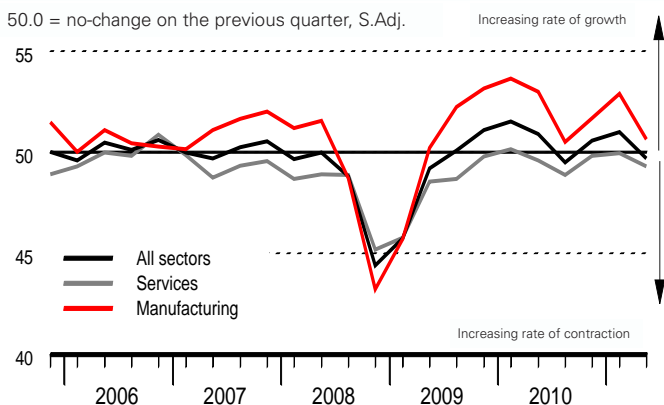
Backlogs of work decline for first time in three quarters.

Outstanding business decreased in Q2 2011, following a two-quarter period of backlog accumulation. That said, the rate of depletion was only slight. The drop in work-in-hand (but not yet completed) primarily reflected a further moderation in new order growth.

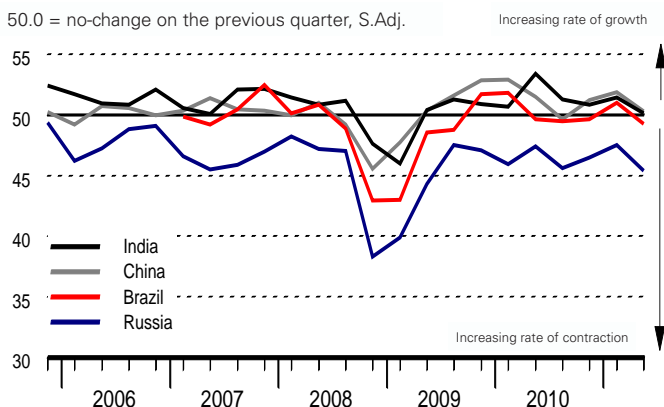
After stagnating in Q1, the level of unfinished business in the service sector fell marginally during Q2. In contrast, manufacturers reported a rise in backlogs of work, although the pace of growth was the slowest in three quarters.

Looking at the largest emerging markets, Brazil and Russia recorded decreases in outstanding business, with the decline in the latter the most marked for two years. Conversely, China and India both saw a rise in work-in-hand, although rates of accumulation were only marginal.

Outstanding business by sector



Outstanding business in BRIC countries (all sectors)



Employment

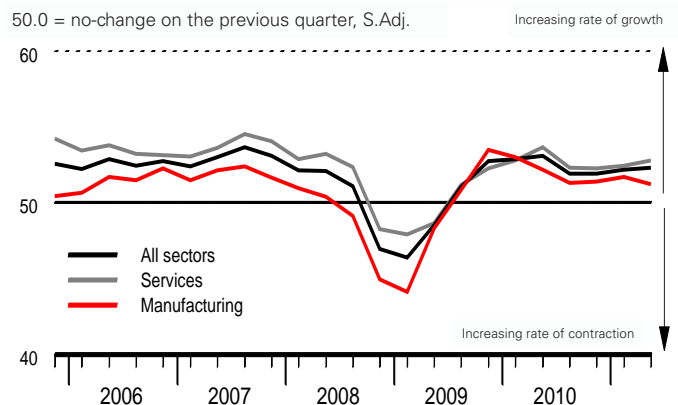
Service sector hiring drives emerging market employment growth to four-quarter high.

Employment in emerging markets rose for the eighth quarter running in Q2 2011. The rate of job creation was the sharpest for a year, but slightly slower than the pre-global recession average.

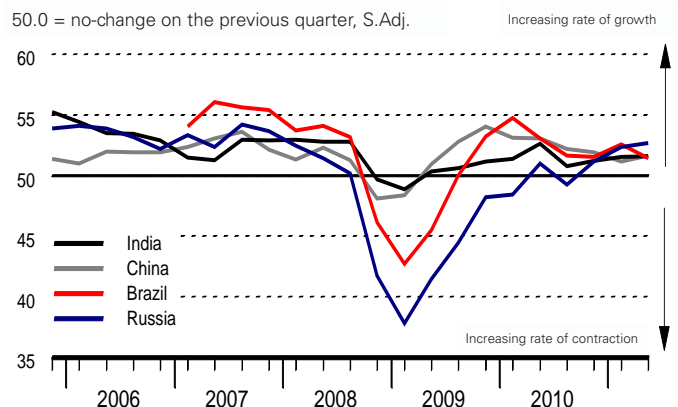
For the fifth quarter in a row, service providers recorded a faster rise in staff numbers than manufacturers, with growth reaching a one-year high in the former. In contrast, manufacturers added to their workforce numbers at the slowest rate since Q3 2009.

Assessing the combined growth of manufacturing and service sector employment in the largest emerging markets, Russia recorded the fastest increase, with growth hitting a three-and-a-half year high. Meanwhile, modest rates of job creation were recorded in Brazil, China and India.

Employment by sector



Employment in BRIC countries (all sectors)



Input Prices

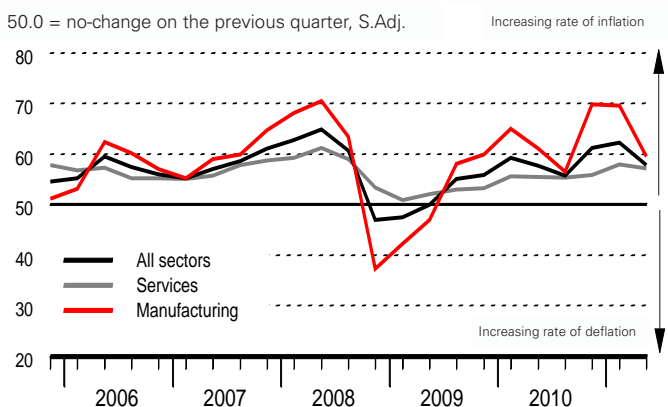
A sharp easing of input cost inflation seen across emerging markets.

Input price inflation in emerging markets eased sharply in Q2 2011, with the latest rise in average costs the least marked for three quarters.

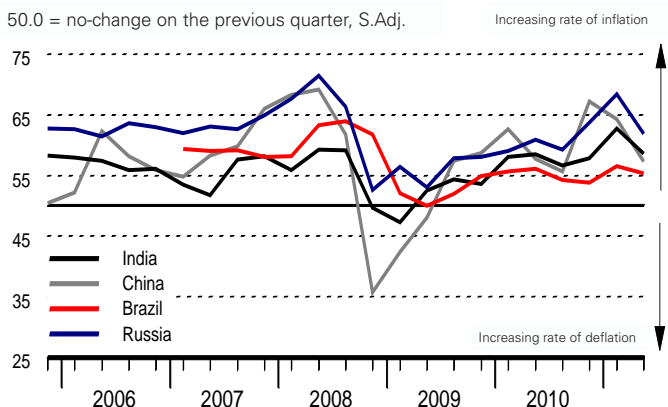
Manufacturers recorded a particularly marked easing of input price inflation, with the relevant index dropping over ten points from Q1's near-record high. Service sector costs also increased at a weaker rate, although the moderation was not as sharp as in manufacturing. Even so, manufacturers continued to report a stronger increase in average costs than service sector firms.

All of the big-four emerging markets saw costs rise at a slower pace in Q2, with Brazil recording the weakest increase. The fastest rate of input price inflation was seen in Russia for the second quarter in a row.

Input prices by sector



Input prices in BRIC countries (all sectors)



Output Prices

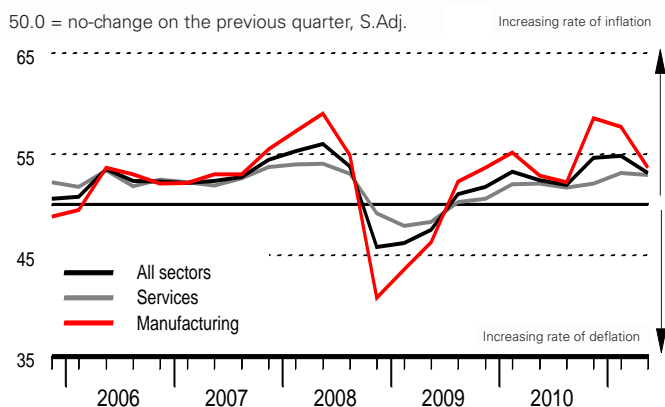
Output price inflation eases to three-quarter low in Q2.

Prices charged for goods and services increased for an eighth successive quarter in Q2. However, a sharp easing of input cost inflation contributed to a more subdued rise in output charges, with the latest increase the slowest since Q3 2010.

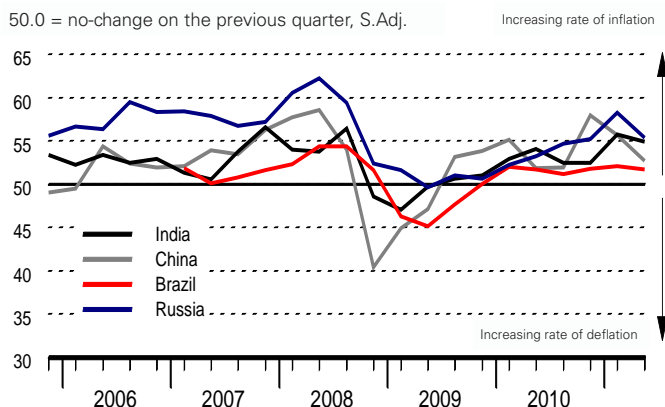
The rate of output price inflation in the manufacturing sector eased sharply to a three-quarter low in Q2. Despite this, average tariffs increased at a sharper rate in manufacturing relative to services, where charge inflation eased only marginally.

Of the largest emerging markets, output prices rose at the fastest rate in Russia, followed closely by India. Brazil recorded the slowest increase in charges, while China saw inflation ease to a three-quarter low. This mainly reflected a much weaker rise in prices charged by manufacturing firms.

Output prices by sector



Output prices in BRIC countries (all sectors)



New Export Orders

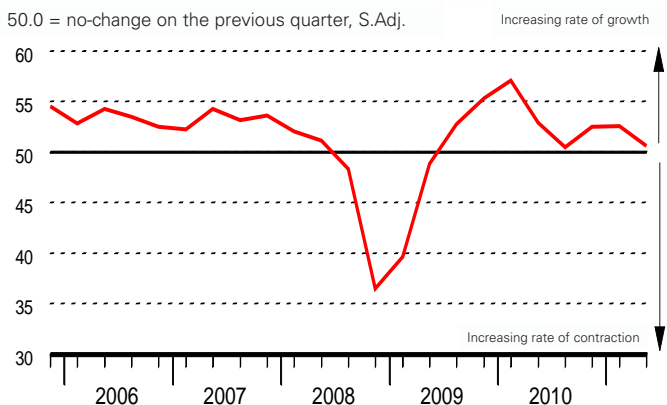
New export orders rise at slowest pace since Q3 2010.

New export business taken by emerging market manufacturers continued to rise in Q2, bringing the current run of expansion to two years. However, the rate of increase moderated since Q1 to the slowest for three quarters.

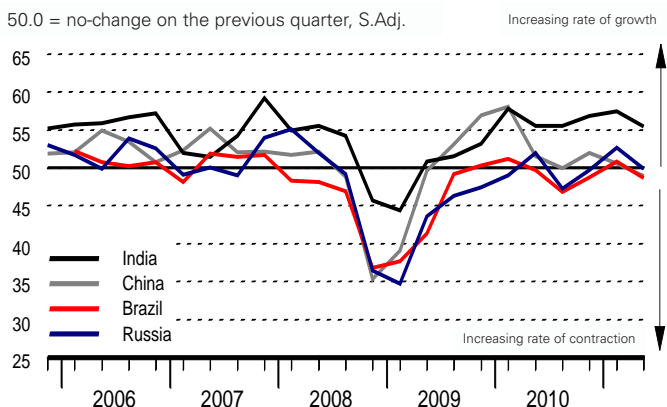
The slowdown in overall new export order growth reflected contractions in three of the four largest emerging markets (Brazil, Russia and China), as well as weaker expansions across almost all other countries/regions monitored by the EMI. Only Israel, Singapore, Saudi Arabia and the UAE bucked the trend, recording sharper rates of increase.

The decline in China was particularly notable as it was the first decrease recorded since Q2 2009.

New export orders (manufacturing)



New export orders in BRIC countries (manufacturing)



Quantity of Purchases

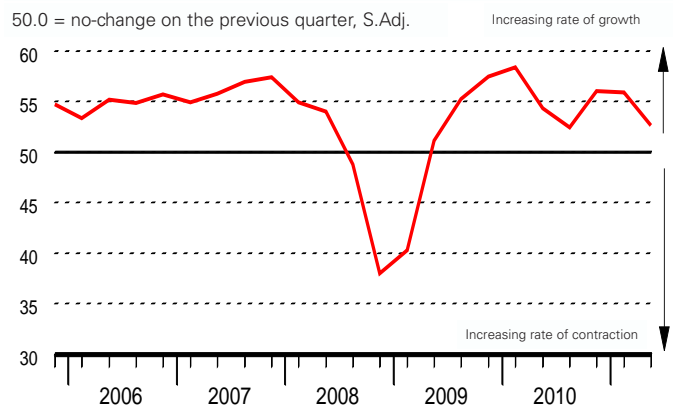
Buying activity growth weakens further.

In response to further inflows of new business, emerging market manufacturers acquired additional supplies of raw materials and semi-finished goods in Q2. However, the rate of increase in purchasing activity eased to the weakest for three quarters.

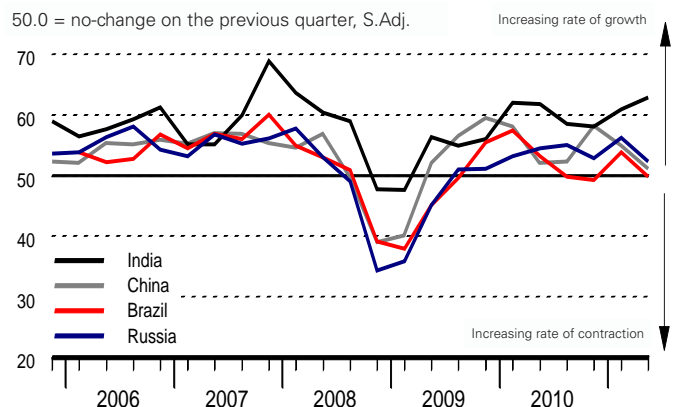
Of the emerging market manufacturing sectors monitored by the EMI, ten posted a rise in buying activity during the second quarter. However, only India and the UAE registered sharper rates of increase. Brazil and Hong Kong, meanwhile, recorded lower levels of input buying.

The most pronounced slowdown in purchasing activity growth was recorded in Turkey, where the sharpest easing in new order expansion was also recorded.

Quantity of purchases (manufacturing)



Quantity of purchases in BRIC countries (manufacturing)



Stocks of Finished Goods

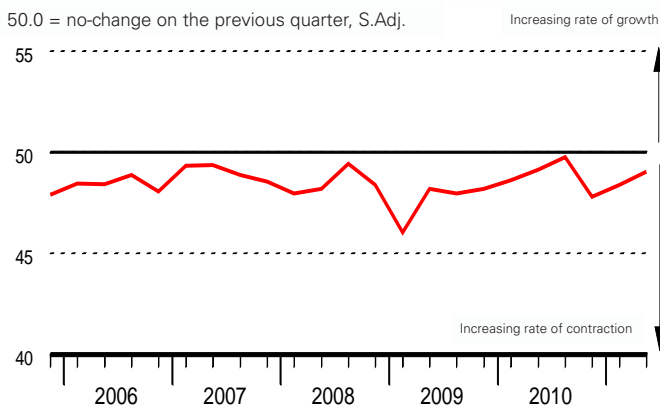
Post-production inventories fall at weakest rate in three quarters.

Finished goods holdings continued to fall in the second quarter of 2011. However, the pace of reduction was only marginal, and the slowest since Q3 2010.

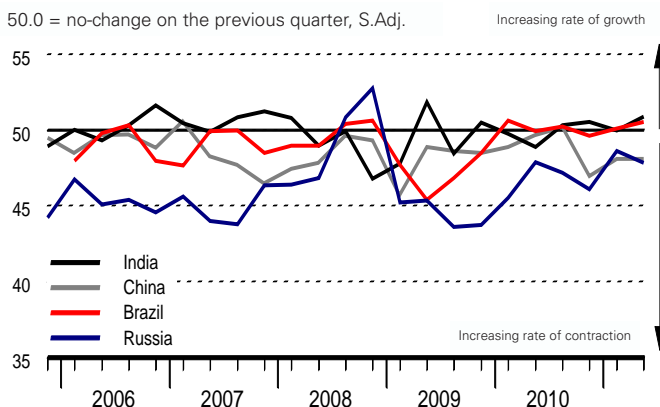
Inventory levels fell across two of the big-four emerging markets, with Brazil and India the exceptions. In China, stock depletion held steady at a modest rate, while Russian manufacturing firms recorded a sharper drop in inventory holdings since the preceding quarter.

Poland and South Korea also saw stock levels decline in Q2, although the pace of reduction in Poland was much slower than in Q1. In contrast, inventories rose for the first time in twelve- and eleven-quarters in the Czech Republic and Turkey respectively, and grew at a series record rate in Taiwan.

Stocks of finished goods (manufacturing)



Stocks of finished goods in BRIC countries (manufacturing)



Stocks of Purchases

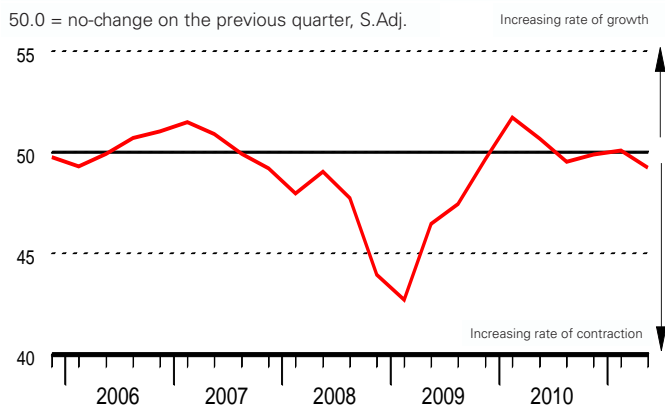
Input stocks decline at sharpest pace for seven quarters.

Stocks of raw materials and semi-finished goods held by emerging market manufacturers fell in Q2, following a rise in the first quarter. Although only marginal, the pace of inventory depletion was the fastest since Q3 2009.

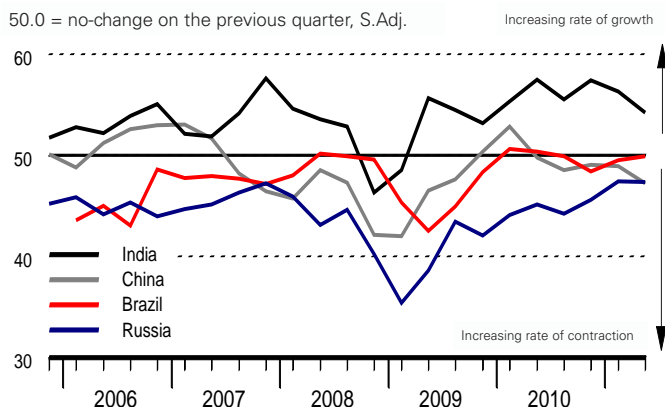
Eight of the emerging market manufacturing sectors covered by the EMI recorded a drop in inventory levels, including Brazil and Russia. Chinese manufacturers also saw a fall in stock holdings, with the rate of depletion the fastest in two years.

Conversely, India registered a solid rise in pre-production inventories, although growth eased to the slowest since Q4 2009. The Czech Republic and Taiwan also saw a rise in stock levels, with the latter recording a series record rate of accumulation.

Stocks of purchases (manufacturing)



Stocks of purchases in BRIC countries (manufacturing)



Suppliers' Delivery Times

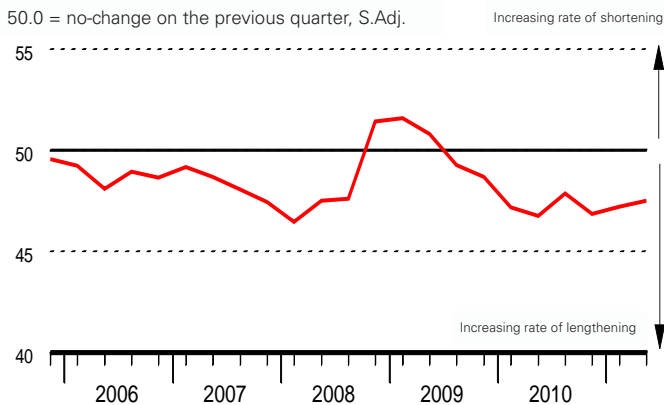
Lead times lengthen for eighth quarter running in Q2.

Amid widespread disruption to the global supply chain in wake of Japan's earthquake and tsunami, the average time taken by suppliers to deliver inputs to emerging market manufacturers lengthened for the eighth consecutive quarter in Q2 2011. However, the rate of deterioration in vendor performance was the slowest in three quarters.

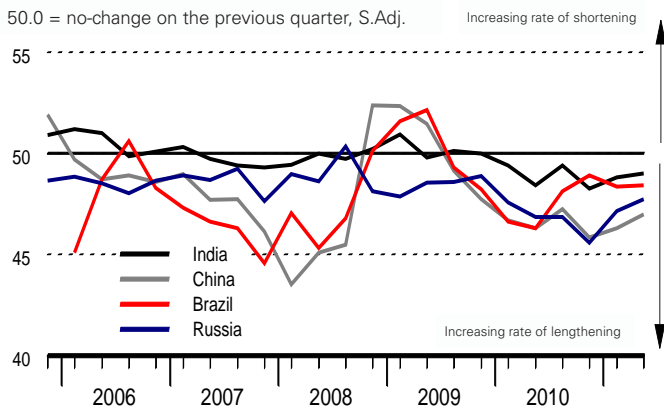
Longer lead times were recorded across nearly all markets included in the EMI, with Saudi Arabia, South Africa and UAE the exceptions. The Czech Republic, Israel and Taiwan saw particularly marked rates of delivery time lengthening.

Of the largest emerging markets, average supplier performance deteriorated at slower rates in China, India and Russia, but held steady in Brazil.

Suppliers' delivery times (manufacturing)



Suppliers' delivery times in BRIC countries (manufacturing)



Business Expectations

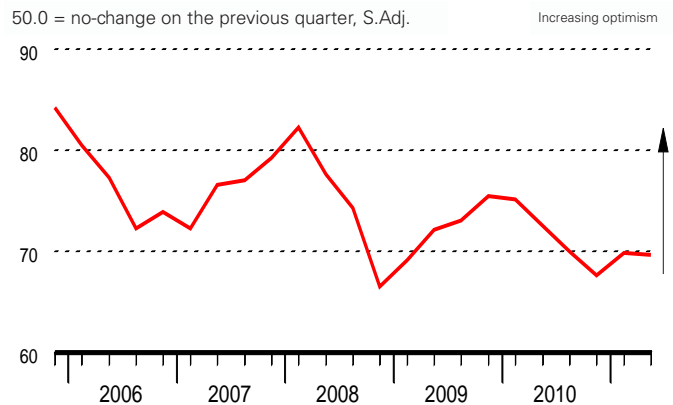
Service sector business confidence remains subdued.

Although service sector optimism was positive in Q2 2011 – confidence was recorded across all four of the largest emerging markets (Brazil, Russia, India and China) – it remained subdued in relation to the long-run trend.

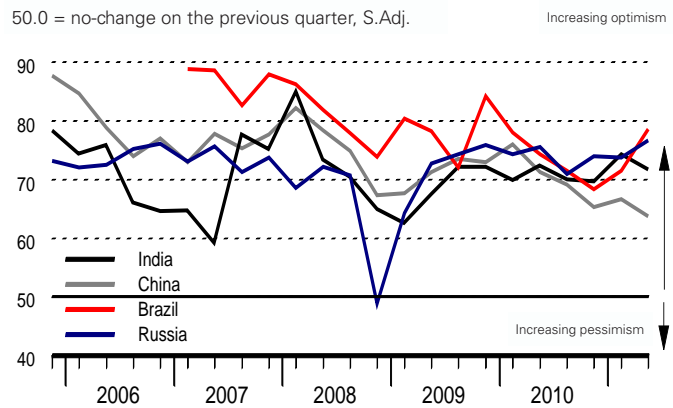
Brazil and Russia each registered stronger optimism regarding future activity levels. However, these improvements were not sufficient to outweigh moderations in service sector confidence across both India and China.

Confidence in the one-year business outlook reached a six-quarter peak in Brazil, and hit a six-and-a-half year high among Russian service providers. In contrast, optimism in China dipped to a record low. Meanwhile, Indian service providers were less optimistic about future activity levels than in Q1.

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 32 countries and also for key regions including the Eurozone. 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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