BBVA | RESEARCH

Economic Outlook

Asia

Third Quarter 2011
Economic Analysis

- **Rapid growth momentum has moderated across the region.** In particular, industrial production and export growth have eased due to headwinds in the second quarter from higher commodity prices and supply disruptions in Japan.
- **Despite increasing downside risks, the outlook for the rest of the year is positive.** The moderation in the second quarter was in line with expectations, and has helped alleviate overheating pressures. We expect a mild rebound in the second half.
- **Inflation remains a concern.** While headline inflation has eased somewhat on stabilizing commodity prices, demand pressures remain, as evidenced by rising core inflation.
- **Further gradual monetary policy tightening is expected**, but at a gradual pace, constrained by concerns of slowing growth and the health of the global economy.
- **Risks are more balanced than in our last quarterly update** due to reduced overheating pressures and a rise in downside risks.

Index

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Summary

As expected, Asia's growth momentum moderated in the second quarter due to headwinds from higher commodity prices and disruptions to supply chains from the March 11 earthquake in Japan. The slowdown followed very strong growth through the first quarter, fueled by both domestic and external demand, which had led to overheating risks. In particular, industrial production and exports have eased across the region, with incoming second quarter GDP outturns now confirming the slowdown.

In addition to the usual concerns about Asia's cyclical growth position and inflationary pressures, market focus has been dominated in the past quarter by external events. In particular, concerns have risen about the impact on global growth and financial stability of ongoing European sovereign debt tensions, the US debt debate, and the outlook for US growth and monetary policy. As elsewhere in the world, these issues have weighed on regional stock markets, although sentiment has generally remained buoyant given the region's strong underlying fundamentals and growth prospects.

Despite downside risks, we expect growth to rebound during the remainder of the year. Stabilizing commodity prices, a recovery in Japan, and strong underlying fundamentals set the stage for a pick up in growth. Continued strong demand from China and India should offset sluggish demand from the US and Europe. More broadly, domestic demand in the region is expected to remain robust on strong income growth and sustained credit expansion.

With the second quarter slowdown largely in line with our previous forecasts, we have made relatively minor adjustments to our 2011 and 2012 projections. For Asia ex-China, we have lowered our 2011 full-year growth projection from 4.3% to 4.1%, mainly due to downward revisions in Japan and Australia on weaker-than-expected outturns to date. We have maintained our growth projection for China at 9.4%. Our 2012 projections remain broadly unchanged, at 5.2% and 9.1%, respectively for Asia ex-China and China.

Inflation remains a challenge, despite some easing from stabilizing commodity prices and the moderation in second quarter growth. Underlying price pressures are still present, as evidenced by rising core inflation. We are revising up our 2011 inflation projection to 4.5% for Asia ex-China (from 4.1% previously), and to 5.3% for China (from 4.9% previously).

We continue to expect further gradual monetary policy tightening, but with the magnitude and pace constrained by concerns about the growth outlook and external environment. Some central banks have begun signaling a softer stance, and we are scaling back our previous interest rate calls for Australia, Indonesia, and Korea. We expect further modest currency appreciation in most currencies as capital inflows resume due to the region's strong growth prospects and rising yield differentials.

Risks have become more balanced since our last quarterly update. While overheating risks remain, they have eased due to the second quarter slowdown. At the same time, downside risks to the growth outlook have risen. There is a possibility that the slowdown of the second quarter may prove more enduring than in our baseline, especially if the external environment were to weaken due to slowing growth in the US and continued financial tensions in Europe.

1. Global outlook: politics at the centre of the economic outlook

Before turning to Asia, we review the Global Outlook. Readers may go directly to the sections on Asia, if they wish, by turning to page 6.

The global economy will continue growing, after a soft patch in the first half

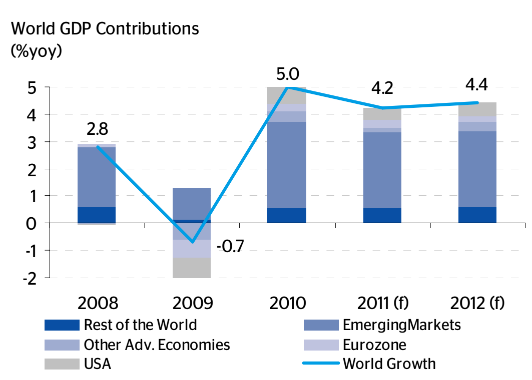
The global economy experienced a mild slowdown in the first half of the year, more pronounced in the US, but also in some emerging countries. Nevertheless, as the factors behind the slowdown are mostly temporary in nature (high oil prices, supply chain disruptions from Japan and bad weather), global growth is set to continue at a robust pace, at 4.2% in 2011 and 4.4% in 2012 (Chart 1).

However, risks to the outlook are now more tilted to the downside. Although the slowdown in activity in the US should be temporary as oil prices stop climbing and international supply chains are restored, the recovery is still weak and prone to relapses, as expected in the aftermath of a financial crisis with highly leveraged consumers. The recent soft patch in the US is a reminder of that, and may dent consumer and producer sentiment going forward.

Both in Europe and the US, fiscal concerns also pose big challenges for policymakers. As solvency concerns have not been addressed, the sovereign debt crisis in peripheral Europe has intensified (Chart 2), with the risk of becoming systemic as market pressure spreads beyond Greece, Portugal and Ireland to Spain, Italy and could eventually claim Belgium. Although its solvency is not in doubt, the US also faces the challenge of a large near-term fiscal adjustment, with the risk that political negotiations deal with short-term fixes rather than a long-term consolidation plan. This would increase the chances of a sudden spike in long-term U.S. yields.

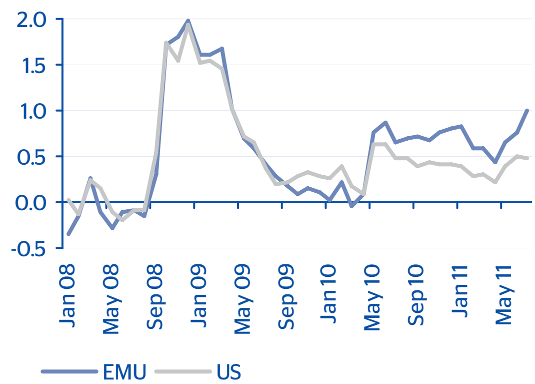
Finally, in emerging economies, overheating concerns may have eased slightly as tightening measures continue to slow growth gradually in Asia and Latin America, although fiscal policies still remain mostly accommodative, thus overburdening monetary authorities.

Chart 1
Global GDP growth and contributions



Source: CEIC and BBVA Research

Chart 2
BBVA Financial Stress Index



Source: CEIC and BBVA Research

Its time to address European solvency concerns with bold political actions

In recent weeks a new round of financial market stress in Europe has extended to Spain and Italy, increasing the chances of the crisis becoming systemic in Europe (with spillovers beyond the EU). This was the result of the delay in providing a second package to Greece and the insistence that private bondholders should bear part of the cost of further financial aid to that country, together with the lack of a comprehensive solution to underlying solvency issues in Greece. This lack of resolve in Greece spilled over to countries without solvency problems such as Spain and Italy, and as a consequence to the European financial sector, which quickly saw their liquidity dry up.

With so much at stake, the Euro group agreed on July 21 to deal with liquidity and solvency concerns. For, the former, it decided to improve the EFSF by allowing it to lend preemptively to solvent countries in distress—much like the Flexible Credit Line from the IMF—and to buy sovereign bonds in secondary markets. Regarding solvency, it softened the conditions of official loans to Greece (also extended to other program countries) and reached an agreement with the private sector for a net present value reduction of their holdings of Greek debt by 21%, through debt swaps and buy-backs.

These have surely been big—and, in some cases, unexpected—steps in the right direction towards solving the European financial crisis. But Europe is not out of the woods, and that has been reflected in only a moderate reduction in risk premia in peripheral countries. Apart from filling in the technical details of the July 21 agreements, there remains a need for further action including an expansion of the EFSF, work towards a closer fiscal union and the introduction of Eurobonds, implementation of economic reforms, and a more definitive solution by EU authorities for Greece's debt and solvency concerns. Until these actions are taken, Europe will continue to be confronted with elevated sovereign spreads (not just for peripheral Europe).

Fiscal consolidation in the US also focuses the attention on politics

In the US, political haggling between two opposite (and highly polarized) approaches to deficit reduction has added much noise, but so far has not increased market pressure on US rates. This reflected the belief that a solution to raising the debt ceiling would be found and default averted. . But an accord to raise the debt ceiling without a plan for long term fiscal consolidation will not address long-term sustainability concerns. Here the risk also lies—as in Europe—in the temptation to kick the can down the road, postpone a solution after the 2012 elections and increase the chances of a spike in long-term interest rates.

Politics also holds the key to the outlook in many countries in Latin America

To a lesser extent, in Latin America, many countries also face uncertainty derived from the future course of politics. In some cases this is derived from perceived weakness by some governments as they are saddled by corruption charges or by massive protests. In other cases, it is the result of recent changes in governments or the uncertainty about the outcome of upcoming elections. Although it is true that the election cycle in the region has had less influence on the economic cycle in the last decade, it is crucial that this capital is not wasted by wide policy swings straying from continuing economic reforms.

Overheating concerns ease in emerging economies

While overheating risks remain in emerging economies, they have receded on the whole with ongoing tightening measures and external headwinds from higher commodity prices and the earthquake in Japan. Importantly, risks of a hard landing in China have diminished with data showing that growth is slowing, but remains robust, still on track for a soft landing. However, inflation in emerging economies remains a concern, with a risk that policymakers may fall behind the curve as they exercise caution about the global environment and currency appreciation.

2. From overheating to worries of a growth slowdown

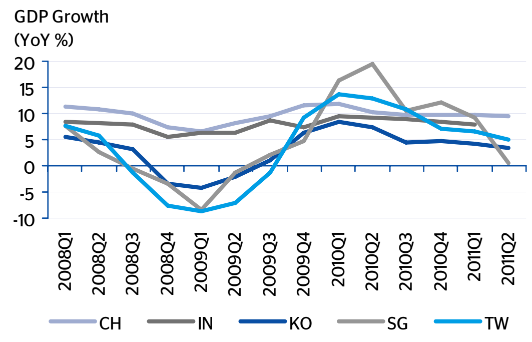
Asia has seen an impressive rebound from the 2008-09 global financial crisis, even as growth in Europe and the US remain sluggish. Fueled by strong demand from the region's largest emerging market economies—especially China, India, and Indonesia— and underpinned by sound underlying fundamentals, the region has racked up impressive growth rates, which generally exceeded expectations through the first quarter of 2011. Indeed, growth was so strong that overheating risks became the predominant concern earlier this year. These risks were evidenced by rapid credit growth, rising inflation, and surging property prices in some countries.

While overheating risks remain, concerns about the sustainability of Asia's growth momentum are now on the rise. This is because of slowing growth indicators in the second quarter and renewed downside risks to the global outlook, as described in the previous section. Prospects of a slowdown in the second quarter were flagged in our previous Asia Outlook due to the expected headwinds from higher commodity prices, disruptions in Japan following the March earthquake and tsunami, and spillovers from the European debt crisis through the risk aversion channel. So far, the resulting slowdown has been in line with our expectations and has helped reduce overheating pressures for the time being.

In addition to the usual concerns about the region's cyclical growth position and inflationary pressures, market focus during the past quarter has been dominated by external events. In particular, concerns have risen about the impact on global and regional growth of ongoing European sovereign debt tensions, the US debt debate, and the outlook for US growth and monetary policy. As elsewhere in the world, these issues have weighed on regional stock markets, although sentiment has generally remained buoyant given the region's strong underlying fundamentals and growth prospects, as seen in recent currency developments (see discussion below and Charts 19-22).

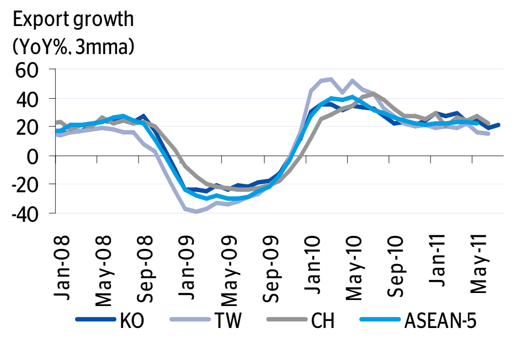
While downside risks have increased due to the external environment, we continue to hold a positive outlook for the region. In particular, we expect growth to rebound gradually in the second half of the year as disruptions from Japan dissipate and as commodity prices ease. In view of ongoing inflationary pressures, we expect central banks to continue tightening monetary policy, although the scope and pace of interest rate hikes is likely to be constrained as policy makers exercise caution in light of the uncertain external outlook.

Chart 3
Asia's growth moderated in the second quarter



Source: CEIC and BBVA Research

Chart 4
Export growth is slowing, but is still robust

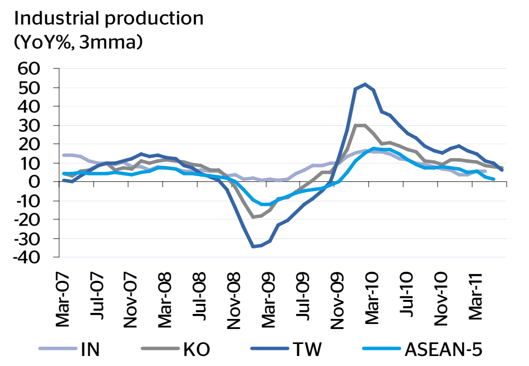


Source: CEIC and BBVA Research

Headwinds to growth result in moderating Q2 indicators

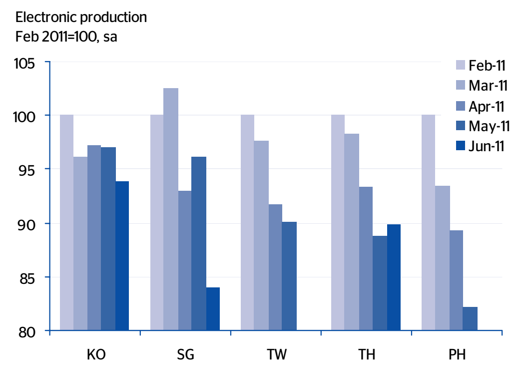
After better-than-expected outturns in the first quarter of the year, growth slowed in the second quarter, as seen in the set of Q2 GDP readings released so far, for China (9.5% y/y), Korea (3.4 y/y), Taiwan (4.9% y/y) and Singapore (0.5% y/y) (Chart 3). High frequency indicators for exports, industrial production, and purchasing manufactures' indices are consistent with the slowdown in GDP (Chart 4, 5, 6 and 7), and appear concentrated in countries and sectors most vulnerable to supply chain disruptions from Japan, such as Thailand's automobile industry and the electronics production in Taiwan, Singapore, and the Philippines (in contrast, electronics production has held up in Korea, which is an indication, as expected, that some firms may have benefited by filling the void left from production problems in Japan) (Chart 6 and box on page 12). Adding to the slowdown from supply chain disruptions more generally has been the pass-through of higher global oil prices (Chart 8).

Chart 5
Industrial production also slowed in Q2...



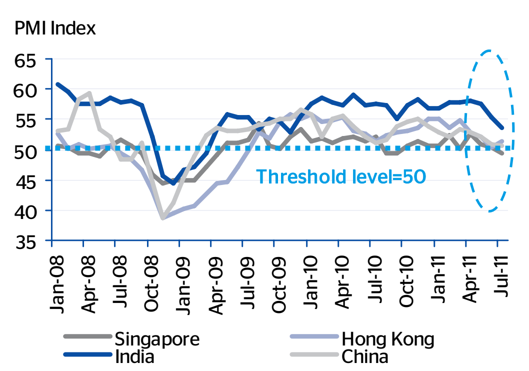
Source: CEIC and BBVA Research

Chart 6
...especially in the electronics sector, reflecting Japan's supply disruptions and weaker exports...



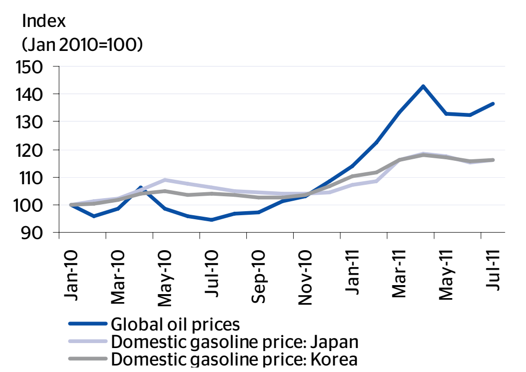
Source: CEIC and BBVA Research

Chart 7
PMI is weakening across Asia



Source: CEIC and BBVA Research

Chart 8
Higher global oil prices have been passed through domestically

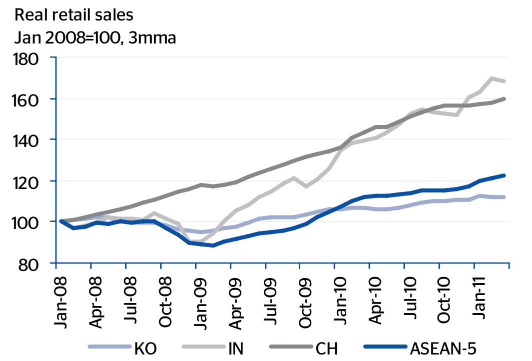


Source: Bloomberg, CEIC and BBVA Research

On the domestic side, drivers of demand are continuing to hold up. Retail sales have been on the rise in most economies (Chart 9), helped by wage and income growth stemming from strong labor markets (Chart 10). Meanwhile, buoyant credit growth appears to be continuing, which is further supporting domestic demand (Chart 11).

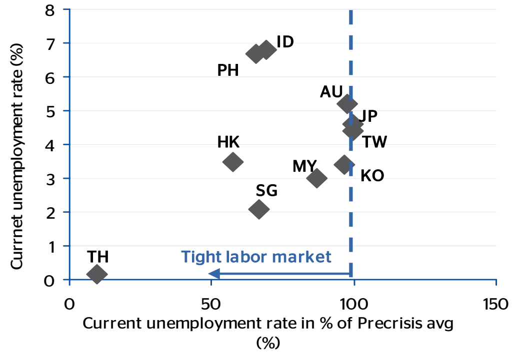
Outside of China and India, whose authorities' have been more aggressive in slowing credit growth, rapid bank lending reflects still accommodative monetary policies. While robust credit growth has been a welcome sign of strong domestic demand, it has also raised concerns of overheating and financial stability in some cases. Loan-to-deposit (LTD) ratios are trending up (Chart 12). Credit growth has been especially strong in Hong Kong (28.1% y/y in June), the highest in Asia, and while still in a safe range, the LTD ratio has risen to 84% from 71% in early 2010. A surge in lending to mainland Chinese companies and strong mortgage demand have been the main drivers. Concerned about the possibility of an abrupt tightening of liquidity conditions, Hong Kong's Monetary Authority (HKMA) imposed stress tests on banks last May and further tightened residential mortgage lending requirements in June. In Korea, where credit growth remains relatively sluggish, rising household debt (150% of disposable income at end-March 2011), has led the authorities to implement measures to limit household borrowing, including stricter capital requirements for high-risk mortgage credits and tax incentives to encourage borrowing at fixed interest rates.

Chart 9
Trends in retail sales suggest healthy domestic demand



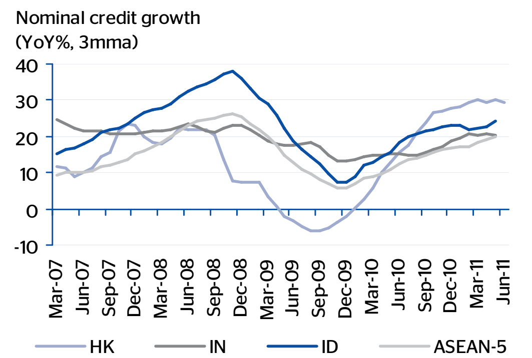
Source: CEIC and BBVA Research

Chart 10
Unemployment rates are well below pre-crisis averages in nearly all Asian economies



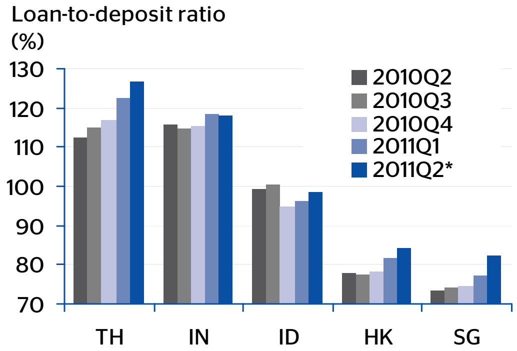
Source: CEIC and BBVA Research

Chart 11
Rapid credit growth in most Asian economies is helping to boost domestic demand



Source: CEIC and BBVA Research

Chart 12
Loan-to-deposit ratios are trending up

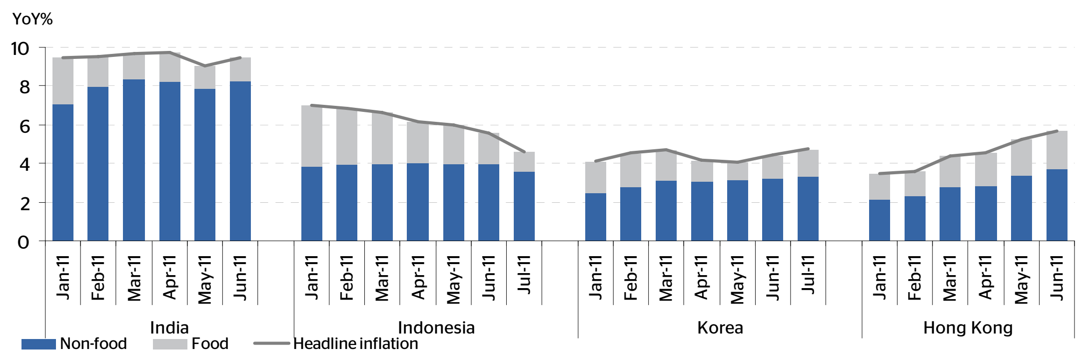


* End of May 2011 data for India, Indonesia, and Thailand
Source: CEIC and BBVA Research

Inflation and overheating pressures remain, despite the growth slowdown

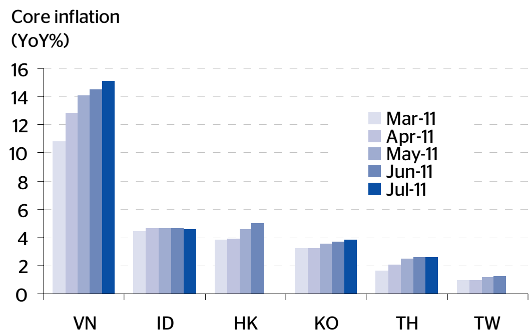
Headline inflation has eased in a number of countries due to stabilizing commodity and food prices. As a result, inflation rates may have now peaked in a couple of countries such as China and Indonesia. However, trends in headline inflation mask underlying demand pressures, with non-food components becoming an increasingly significant contributor (Chart 13) and core inflation rates trending up (Chart 14).

Chart 13
Though headline inflation is easing in some countries, pressures from non-food components is rising



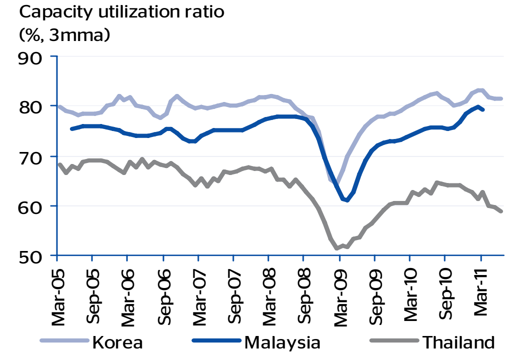
Source: CEIC and BBVA Research

Chart 14
Core inflation is trending up



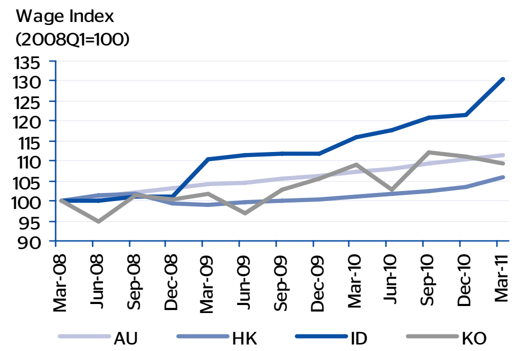
Source: CEIC and BBVA Research

Chart 15
Capacity utilization ratios are generally high by historic norms



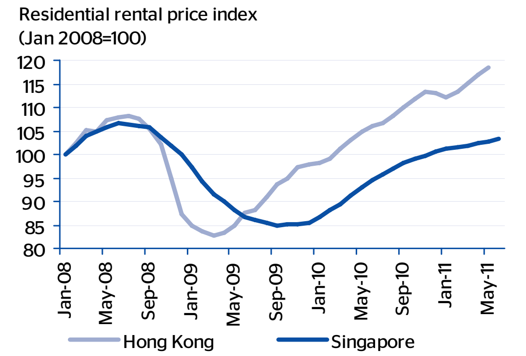
Source: CEIC and BBVA Research

Chart 16
Wage levels are rising



Source: CEIC and BBVA Research

Chart 17
Housing rents are rising rapidly in Hong Kong and Singapore



Source: CEIC and BBVA Research

Supply side price pressures have not disappeared completely. For example, pork prices in China jumped by 57% y/y in June, helping to drive inflation to a higher-than-expected three-year high of 6.4% y/y, spurring the government to release its pork reserves. In Australia, higher fruit prices due to floods caused inflation to rise to 3.6% y/y in Q2, above the government's inflation target range of 2-3%.

Despite these special factors, inflation appears to be driven by demand-side factors, pointing to ongoing overheating risks despite the moderation in growth. Output gaps across the region are closed, as suggested by generally high capacity ratios (Chart 15) and tight labor market conditions (Chart 8 above and (Chart 16)). In economies with booming property markets, such as Hong Kong and Singapore, rental rates, which have a high weight in the CPI basket (29.2% and 20.0%, respectively) are now feeding into CPI inflation, following the previous surge in housing prices (Chart 17).

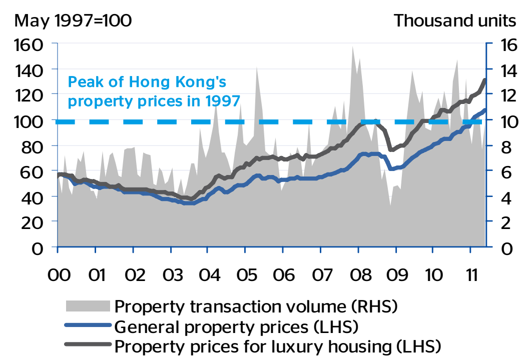
Inflation due to overheating pressures remains a particular concern in India and Vietnam, at 9.4% y/y in June and 22.2% y/y in July, respectively. In Vietnam, the pressures have been especially severe as the authorities struggle to maintain macro stability, with currency depreciation adding to the inflation dynamics. Inflation in Hong Kong and China have become major social issues, with the former being vulnerable due to its peg to the US dollar that deprives the economy of an independent monetary policy at a time when its booming cyclical position differs so dramatically from the US, from whom it effectively imports its monetary policy.

At the other end of the inflation extreme are Japan and Taiwan. Japan has finally emerged from deflation, with the CPI rising to 0.2% y/y in June, partly on supply shortages following the March 11 earthquake. Inflation has been rising in Taiwan, but remains exceptionally low at just 1.9% y/y in

June (inflation may have been temporarily high due to a recent health scare over contaminated sports and fruit beverages).

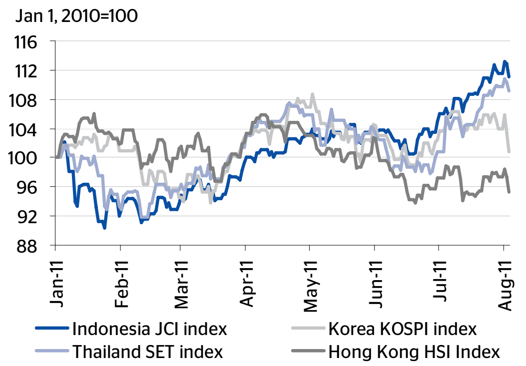
Meanwhile, risks of asset bubbles remain, especially in property sectors in Hong Kong, Singapore and Taiwan (Taipei), though the pace of price increase has been moderating following tightening measures and slower capital inflows due to higher global risk aversion. In China, property price increases have moderated over the past year under the influence of government cooling measures, which include efforts to reign in liquidity, tighten credit, and intensify various macro-prudential measures (see China Real Estate Outlook), In Hong Kong, the HKMA introduced new measures in June, including tighter residential mortgage lending requirements and an increase in land supply. As a result, trading volumes have fallen (Chart 18). In equity markets, share prices have recently weakened on concerns about the US debt ceiling standoff and European debt spillovers (Chart 19). That said, upward trends could well resume, especially given the likelihood of further capital inflows to the region.

Chart 18
Hong Kong's property prices have continued to rise, despite a decline in trading volumes



Source: CEIC and BBVA Research

Chart 19
Stock markets in Asia have recently weakened, in line with global trends



Source: Bloomberg and BBVA Research

Policy tightening continues, although concerns on growth have increased

Central banks in the region are continuing to tighten monetary policy in response to ongoing inflation pressures and still negative real interest rates (Chart 20), That said, the policy focus has begun to shift back toward support for growth given increased global uncertainties. Easing headline inflation has also provided room to slow the pace of interest rate normalization.

India has continued to be most aggressive in monetary tightening given its struggle against high inflation and overheating. The Reserve Bank of India (RBI) announced a larger than expected 50bp hike in July, marking the eleventh rate hike since the tightening cycle began in March 2010. In Taiwan, in contrast, the central bank has maintained a very gradual pace of quarterly interest rate hikes, to help anchor inflation expectations, with another 12.5bp interest rate hike in June, for a cumulative 62.5 basis points since mid-2010.

China, Korea and Thailand have each implemented another 25bp hike in the past three months on concerns of rising core inflation. Nevertheless, increasing concerns over global uncertainties and moderating inflation have led some central banks to postpone further rate hikes, such as in Indonesia, which has been on hold since February, and Australia, which has been on hold since last November, because of sluggish growth after the Queensland floods and, more recently, concerns about the global environment. In Vietnam, the central bank even lowered its repurchase rate to 14% from 15% in spite of double-digit inflation, given the government's long-standing bias in favor of growth.

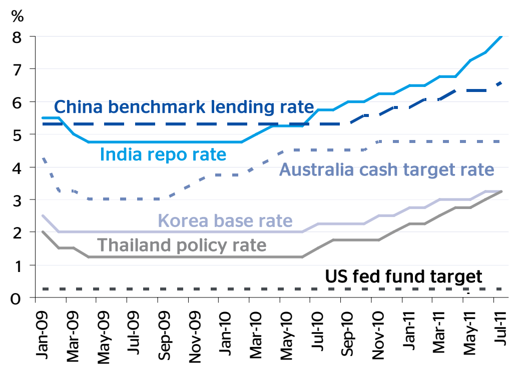
Strong economic fundamentals add appeal to Asian currencies

Despite bouts of global risk aversion, the region continues to be a favorite among international investors because of its strong underlying fundamentals, as in other emerging markets. In particular, sound fiscal positions, low debt levels, along with well-capitalized banking systems and high reserves have helped limit contagion risks, This is evident in recent currency fluctuations, which have been minimal compared to previous episodes of global risk aversion. For example, currency volatility has been much lower than during the initial Greek debt concerns in May 2010

(Charts 21 and 22), suggesting that investors may hold a more sanguine view of the region's ability to weather external shocks. Asian currencies have also exhibited extraordinary resilience compared to other global currencies. Volatility of the Korean Won and the Indonesian Rupiah, both of which are "high beta" currencies, have declined while that of the Euro has risen in recent months, a large contrast compared to events in 2010. Meanwhile, monetary authorities across the region have continued to intervene to prevent rapid currency appreciation (Chart 23).

Chart 20

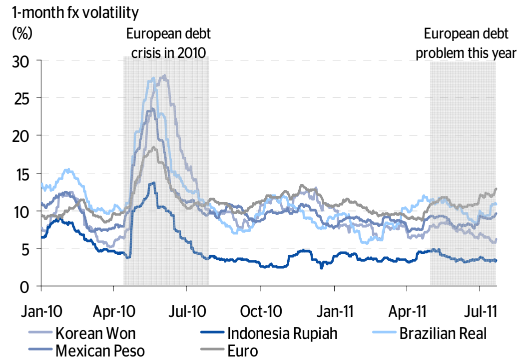
Many Asian countries are still continuing interest rate normalization



Source: CEIC and BBVA Research

Chart 21

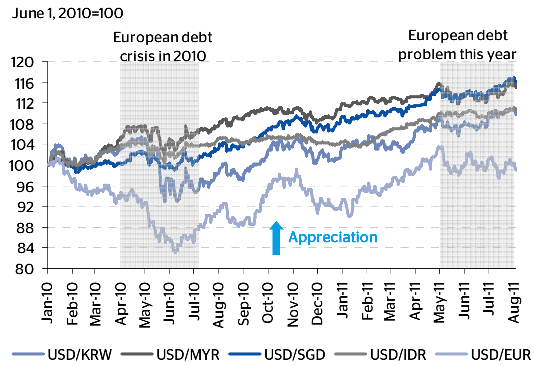
Asian currencies have been more stable in this round of European debt shock



Source: Bloomberg and BBVA Research

Chart 22

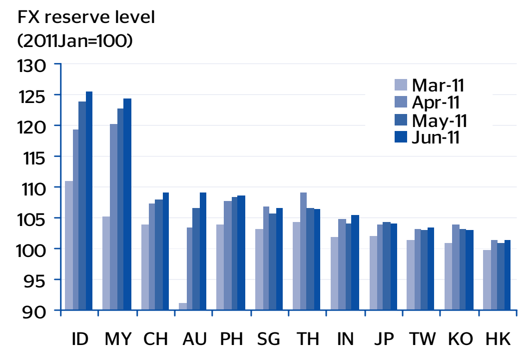
Asian currencies are still appreciating despite higher global risk aversion



Source: Bloomberg and BBVA Research

Chart 23

Reserve accumulation has continued on fx intervention



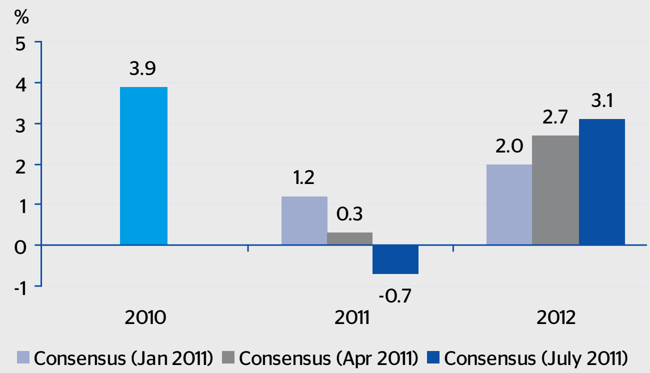
Source: CEIC and BBVA Research

Box: Update on Japan's recovery from the March 11 earthquake and tsunami

While the economic impact of Japan's devastating earthquake and tsunami has turned out to be larger than previously expected, a rebound is under way.

As the extent of supply disruptions become apparent, full year GDP consensus growth estimates for 2011 have been progressively marked down (Chart 24). The downward revisions were also due in part to the fact that first quarter GDP growth turned out to be much weaker than expected, at -3.5%, q/q saar, confirming a technical recession (two consecutive negative quarterly growth) and revealing that even before the earthquake, growth momentum was on the weak side. Nevertheless, while uncertainties to the outlook remain, particularly with respect to Japan's power supply, evidence continues to mount that industrial production and exports have bottomed out, setting the stage for a rebound in the second half of the year.

Chart 24
Japan's 2011 growth outlook has been progressively marked down on the impact of evolving supply disruptions



Source: Asia-Pacific Consensus Forecasts and BBVA Research

Policy responses

The government and the Bank of Japan have implemented a set of post-quake stimulus packages to facilitate relief work and reconstruction and bring the afflicted region back to life. On the monetary policy front, the BOJ doubled its asset-buying program to ¥10 trillion at the very outset, and later unveiled a ¥1 trillion yen scheme to provide funds to banks for lending to distressed businesses in the affected areas. It also expanded its lending facility to support recovery by ¥0.5 trillion, and has kept its policy rate unchanged at 0-0.1%. One of the challenges on the monetary front has been a sharp appreciation of the Yen (which broke through 77 yen per dollar in late July and early August), which has served as somewhat of a safe haven in recent weeks due to the fallout of the US debt debate and ongoing uncertainties in Europe. On August 4, the authorities announced intervention to stem to yen's rise for the second time this year. If the economic recovery falters, further monetary easing measures are possible in the coming months.

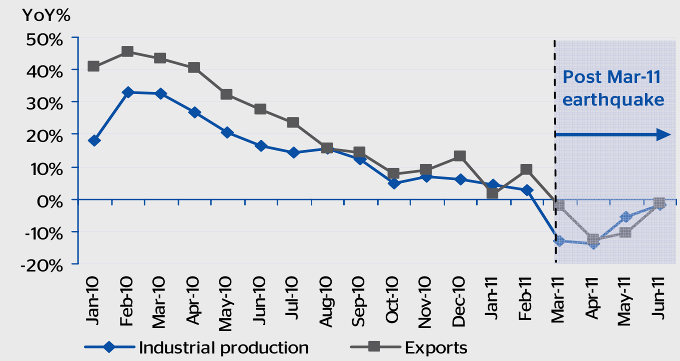
On the fiscal front, in May parliament passed an extra budget of ¥4 trillion (about 0.8% of GDP) to clear rubble and to finance the building of temporary housing, restore public facilities and infrastructure, and support businesses hit by the disaster. Given the limited room for fiscal spending—Japan's gross debt stands at around 200% of GDP—the government diverted some funds originally for other uses to finance the extra budget, so as not incur new debt. In July the government approved a second extra budget of ¥2 trillion (about 0.4% of GDP) for reconstruction, to be spent on rebuilding and compensating victims of the Fukushima nuclear crisis. A third, and more comprehensive, extra budget is expected by the end of August, and is likely to exceed ¥10 trillion (about 2% of GDP). This would bring Japan's fiscal deficit to 10.5% of GDP in 2011, placing even great pressure on an already challenging fiscal situation, which led Fitch and S&P to lower their sovereign outlook to negative last April, with Fitch following suite in May.

Signs of recovery

Despite the severity of the disaster and subsequent nuclear fears, the economy is poised for a rapid recovery. Key indicators bottomed out in April (Chart 25), and the resumption of supply chains is occurring more quickly than expected. Meanwhile, the latest quarterly Tankan survey confirms that business sentiment is recovering and that manufacturers are optimistic about business conditions for the third quarter (Chart 26). Meanwhile, on the consumer side, retail and automobile sales are rising after a plunge in March (Chart 27).

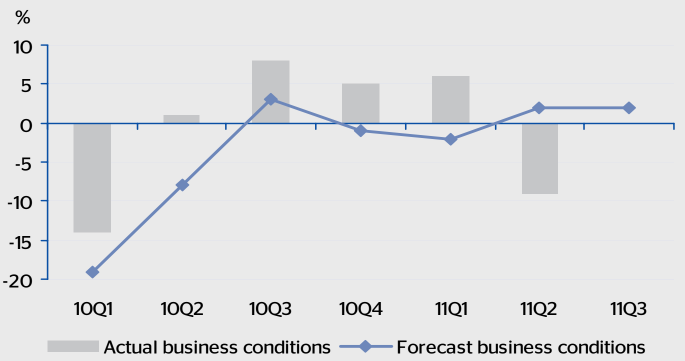
Rising business confidence and consumer spending, together with the stimulus of post-quake reconstruction spending, should all lead to a resumption of growth in the second half of the year. However, uncertainties remain, especially with respect to the outlook for power outages given ongoing concerns in Japan about the safety of and reliance on nuclear energy, which accounts for about 30% of total electricity production. As has been widely reported in the press, currently 35 of 54 nuclear reactors are under inspection, and the remainder are scheduled to be inspected in 2012. Restarting these nuclear reactors will require the approval of local governments, who in turn face a public that remains skeptical about the safety of such plants. In addition, the Yen's recent strength, as noted above, could undermine export growth, on which Japan depends heavily.

Chart 25
Japan's production and exports bottomed out in April...



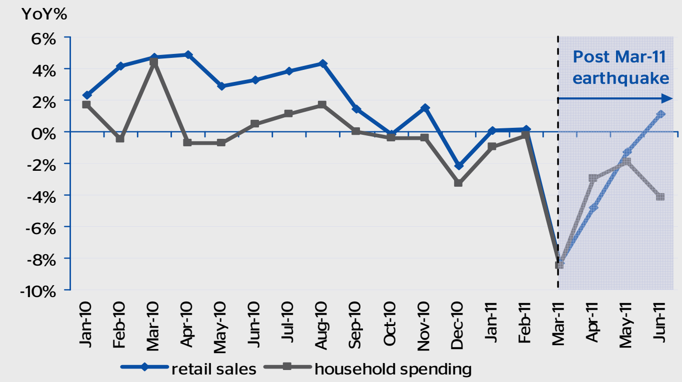
Source:: Haver Analytic and BBVA Research

Chart 26
The manufacturing sector remains upbeat on business conditions



Source:: Haver Analytic and BBVA Research

Chart 27
Private consumption has bottomed out ...



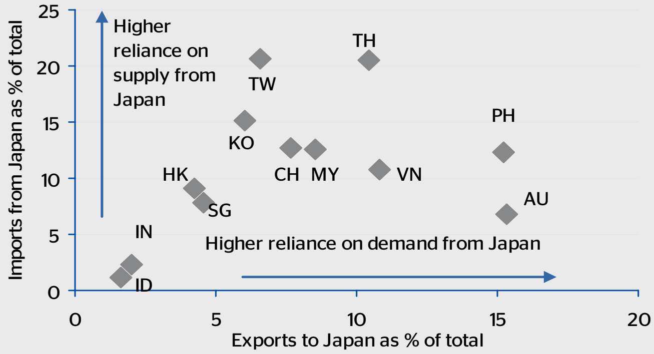
Source:: Haver Analytic and BBVA Research

Impact outside of Japan

As is well known, Japan is a key supplier of high-tech components and an exporter of automobiles and consumer electronics. As a result, the impact of the earthquake on other economies has been quite large due to the impact of disruptions in the automobile, electronics and other manufacturing production chains.

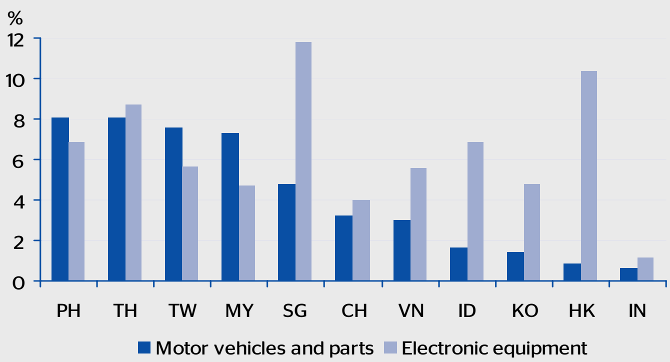
As shown in Chart 28, within the Asia region, countries such Thailand, Taiwan, and the Philippines depend highly on Japan for imports of components and/or as a market for their exports. Not surprisingly, these economies appear to have been the most affected. The importance of Japan's high-tech export products in Asia's production chains is illustrated in Chart 29, where it can be seen that the value added of such products in Asian exports is quite high. Since the earthquake, there has been a noticeable decline in such exports to the rest of Asia, leading to supply disruptions, especially in the Philippines and Thailand. (Chart 30) Nonetheless, as Japan's economy rebounds in the second half year, the normalization of supply chains and Japan's reconstruction are expected to boost the region's export prospects.

Chart 28
Asia's trade exposure to Japan



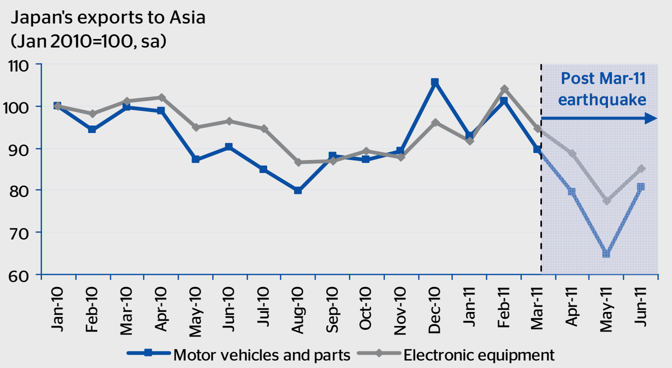
Source: CEIC and BBVA Research

Chart 29
Japanese value added share in the exports of Asian countries



Source: IMF,, Koopman, (2010), and BBVA Research,

Chart 30
A sharp decline in Japan's auto and electronics exports to the rest of Asia



Source: CEIC and BBVA Research

3. Expecting a rebound as headwinds fade

The recent slowdown has helped to alleviate, but not yet eliminate, overheating pressures and inflation. Policy makers therefore face the challenge of continuing to tighten monetary policy to stem inflationary pressures, as they assess growth indicators and prospects for a rebound in the context of an increasingly uncertain external environment.

Although downside risks have increased due to prospects of a slowdown in the global economy, we continue to believe that the region is poised for a resumption of strong growth in the second half of the year as headwinds from rising oil prices and disruptions in Japan dissipate. Even if external demand were to weaken beyond our current baseline, sustained intra-regional trade from continued strong growth in China and India should help the region to sustain growth, all the more so given the region's strong underlying fundamentals and room for fiscal and monetary policy manoeuvre. In the meantime, demand side pressures are likely to continue putting upward pressure on inflation, necessitating further gradual monetary tightening.

Our baseline sees a growth rebound in H2

With the slowdown in second quarter growth indicators broadly in line with expectations from our previous Asia Outlook, revisions to our projections mainly reflect fine-tuning. On the whole, we are revising down our 2011 GDP forecast for Asia ex-China from 4.3% previously to 4.1% (largely due to the downward revision to Japan), and we are maintaining our projection for China unchanged at 9.4%. Our baseline incorporates an expected rebound in the second half of the year (Chart 31). For 2012, we have raised our projection slightly to 5.2%, from 5.1% due to minor adjustments in Japan's growth trajectory, and we have kept our projection for China unchanged at 9.1%. That said, the increase in global uncertainties may pose some downside risks to our projections, especially for the region's smaller and more export-dependent economies which rely heavily on external demand.

Most of our 2011 GDP projections remain unchanged (Table 1). Our biggest revision is for Japan, from +0.5% to -0.3%, and for Australia, from 3.0% to 2.3%, in both cases reflecting weaker than expected Q1 outturns. We have raised our projections slightly for Hong Kong (from 4.8% to 5.0%) and Thailand (from 3.8% to 4.0%) due to stronger-than-expected Q1 growth outturns. Thailand,'s growth outlook has also brightened following the peaceful presidential election in July and an ongoing resumption of supply chains with Japan.

Inflation pressures remain due to strong demand

We are revising up our regional inflation outlook for 2011 from 4.1% to 4.5% for Asia ex-China, and from 4.9% to 5.3% for China, mainly due to higher than expected outturns through June/July this year. Besides China, the most significant upward revisions are for Vietnam and India where, as described above, overheating pressures have been especially severe. We are revising a few projections downward, for Indonesia (6.2%), the Philippines (4.6%) and Taiwan (1.6%) (Table 2). While the stabilization in commodity prices is helping to ease headline inflation, which is likely to have peaked in China and Indonesia, capacity utilization is high, and we expect underlying core inflation to continue to drift higher.

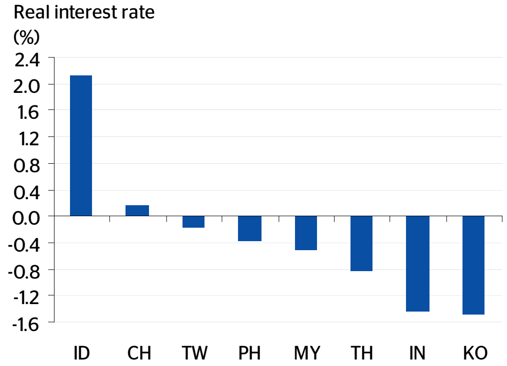
Pace of policy tightening may slow on growth concerns

Monetary conditions remain loose across the region, with real interest rates still negative in many cases (Chart 32). In view of this and underlying inflation pressures, we expect a number of central banks to continue raising interest rates during the remainder of the year. However, we believe the pace and magnitude of such increases will be modest, given the slowdown that has occurred and rising concerns about the external outlook. Accordingly, we are scaling back our interest rate hike calls for Australia, Indonesia, and Korea (we now expect just one more 25bp hike for Australia and Indonesia and two more 25bp hikes for Korea for the reminder of this year). For Taiwan, we expect the central bank to maintain its pace of quarterly interest rate hikes of 12.5bp, ahead of the Presidential election next year (Table 3). On the fiscal front, our projections continue to incorporate smaller deficits in 2011. Recent easing commodity prices should make governments' fiscal targets more achievable by reducing the burden of food and energy subsidies.

Chart 31
We expect a rebound in the region's growth during the remainder of the year

Source: CEIC and BBVA Research

Chart 32
Real interest rates in many Asian economies remain negative



Note: calculated using current inflation
Source: CEIC and BBVA Research

Currency appreciation pressures persist, though they have eased

We expect currency appreciation to continue for most Asian currencies on strong external balances, supported by sound growth prospectus and rising yield differentials. That said, the pace of appreciation against the USD is expected to be quite modest, due to some easing of capital inflows and further official fx intervention (Table 4). The outlier is the Vietnam Dong, which we expect to depreciate due to the high rates of inflation and ongoing macro instability.

4. Risks are more broadly balanced

While overheating risks remain, downside risks to the growth outlook have risen since our last quarterly update. There is a risk that the slowdown of the second quarter may prove more enduring than in our baseline, especially if the external environment were to weaken due to slowing growth in the US and continued financial tensions in Europe. As a result, risks to the outlook have become more balanced.

Overheating risks have eased with the slowdown in Q2, but nevertheless remain present due to tight capacity and strong labor market conditions. Despite moderating commodity prices, inflation could well surprise to the upside, particularly if central banks become complacent in light of the recent slowdown or if they remain excessively cautious in view of the uncertain growth outlook. In addition, commodity prices themselves could reverse course if there are unexpected supply disruptions from adverse weather conditions or an intensification of geopolitical instability in the Middle East or elsewhere.

Downside risks to growth emanate from possible spillovers from financial tensions in Europe, mainly through the external demand channel, and less so through direct financial channels due to Asia's strong underlying fundamentals. Slower growth in the US presents an additional downside risk, particularly for Asia's smaller and more open economies, such as Hong Kong and Singapore. Within Asia, downside risks relate to the possibility of a weaker-than-expected rebound in Japan, especially due to power shortages, and to ever-present risks of a hard landing in China, which we consider remote. If downside risks were to materialize, however, most Asian economies could cushion some of the growth impact given their room to slow the pace of monetary tightening or through further fiscal stimulus as needed.

Country-specific risks also bear watch. Japan, as noted above, is coping with fiscal pressures due to its high debt burden and costs of reconstruction. Overheating risks remain in India, and Vietnam is continuing to struggle to maintain macro stability. In Hong Kong, rising property rents and housing prices remain a concern, along with concerns about the rapid pace of bank lending. In Thailand, election uncertainties have eased following July's peaceful elections; nevertheless, the country will continue to cope with the political transition to a new government, with risks of renewed instability.

5. Tables

Table 1

Macroeconomic Forecasts: Gross Domestic Product

(YoY% growth rate)	2008	2009	2010	2011 (F)	2012 (F)
U.S.	-0.3	-3.5	3.0	2.1	2.6
EMU	0.3	-4.1	1.7	2.0	1.3
Asia-Pacific	5.2	4.1	8.0	6.2	6.7
Australia	2.4	1.4	2.5	2.3	3.8
Japan	-1.2	-6.3	4.0	-0.3	2.9
China	9.6	9.2	10.3	9.4	9.1
Hong Kong	2.3	-2.7	7.0	5.0	4.5
India	5.1	9.1	8.8	8.1	8.0
Indonesia	6.0	4.6	6.1	6.4	6.7
Korea	2.3	0.3	6.2	4.5	4.5
Malaysia	4.8	-1.6	7.2	5.1	5.4
Philippines	4.2	1.1	7.6	4.5	5.2
Singapore	1.5	-0.8	14.5	6.0	4.8
Taiwan	0.7	-1.9	10.9	4.8	4.9
Thailand	2.5	-2.3	7.8	4.0	4.8
Vietnam	6.3	5.3	6.8	6.2	6.5
Asia ex China	2.3	0.8	6.5	4.1	5.2
World	2.8	-0.7	5.0	4.2	4.4

Source: CEIC and BBVA Research

Table 2

Macroeconomic Forecasts: Inflation (Avg.)

(YoY% growth rate)	2008	2009	2010	2011 (F)	2012 (F)
U.S.	3.8	-0.3	1.6	2.8	2.2
EMU	3.3	0.3	1.7	2.7	1.8
Asia-Pacific	5.7	0.3	2.7	4.8	3.6
Australia	4.4	1.8	2.8	3.2	2.9
Japan	1.4	-1.4	-0.7	0.3	0.5
China	6.0	-0.8	1.2	5.3	3.9
Hong Kong	4.3	0.6	2.3	5.2	3.7
India	8.7	2.4	9.6	9.0	6.5
Indonesia	9.9	4.8	5.1	6.2	5.9
Korea	4.7	2.8	3.0	3.8	3.1
Malaysia	5.4	0.6	1.7	3.1	2.7
Philippines	9.3	3.2	3.8	4.6	4.0
Singapore	6.6	0.6	2.8	4.3	2.8
Taiwan	3.5	-0.9	1.0	1.7	1.4
Thailand	5.5	-0.8	3.3	3.8	3.0
Vietnam	23.2	6.9	10.0	19.0	12.0
Asia ex China	5.5	1.1	3.7	4.5	3.5
World	6.1	2.2	3.0	4.8	4.1

Source: CEIC and BBVA Research

Table 3
Macroeconomic Forecasts: Exchange Rates (End of period)

		2008	2009	2010	2011 (F)	2012 (F)
U.S.	EUR/USD	0.70	0.70	0.75	0.74	0.75
EMU	USD/EUR	1.50	1.40	1.34	1.36	1.33
Australia	USD/AUD	0.67	0.90	1.02	1.04	0.95
Japan	JPY/USD	96.1	92.1	81.1	88.0	87.0
China	CNY/USD	6.84	6.83	6.61	6.30	6.00
Hong Kong	HKD/USD	7.75	7.75	7.77	7.80	7.80
India	INR/USD	48.6	46.6	44.7	45.0	44.0
Indonesia	IDR/USD	10838	9395	8996	8500	8700
Korea	KRW/USD	1364	1166	1126	1020	988
Malaysia	MYR/USD	3.56	3.52	3.06	2.88	2.83
Philippines	PHP/USD	48.3	46.8	43.8	42.5	43.0
Singapore	SGD/USD	1.49	1.40	1.28	1.24	1.22
Taiwan	NTD/USD	33.0	32.3	29.3	28.2	27.8
Thailand	THB/USD	34.8	33.3	30.1	30.5	30.5
Vietnam	VND/USD	16598	17942	19498	21500	22000

Source: CEIC and BBVA Research

Table 4
Macroeconomic Forecasts: Policy Rates (End of period)

(%)	2008	2009	2010	2011 (F)	2012 (F)
U.S.	0.61	0.25	0.25	0.25	1.25
EMU	2.73	1.00	1.00	1.75	2.00
Australia	4.25	3.75	4.75	5.00	5.50
Japan	0.10	0.10	0.10	0.10	0.25
China	5.31	5.31	5.81	6.81	7.31
Hong Kong	0.50	0.50	0.50	0.50	1.50
India	6.50	4.75	6.25	8.00	7.75
Indonesia	9.25	6.50	6.50	7.00	6.50
Korea	3.00	2.00	2.50	3.75	4.25
Malaysia	3.25	2.00	2.75	3.50	3.75
Philippines	5.90	4.00	4.00	5.00	5.50
Singapore	1.00	0.69	0.48	0.45	1.45
Taiwan	2.000	1.250	1.625	2.125	2.625
Thailand	2.75	1.25	2.00	3.50	3.50
Vietnam	8.50	8.00	9.00	11.00	9.00

Source: CEIC and BBVA Research

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