BBVA | RESEARCH

Economic Outlook

Asia

Fourth Quarter 2011
Economic Analysis

- **Growth in Asia has continued to moderate due to weakening external demand.** Strong domestic demand has been a partial offset, but with exports slowing, the growth rebound previously expected in the second half of the year has not materialized.
- **The growth outlook is still robust, although downside risks have increased due to the uncertain global environment.** We have revised down our 2011-12 Asian growth projections, but only modestly on expectations of strong domestic demand and a gradual rebound in exports during the course of 2012.
- **The moderation in growth has helped ease overheating pressures, and inflation has begun to recede**. This has increased the scope for policy stimulus. We expect some further monetary easing if the external environment worsens.
- **Risks have shifted to the downside since our last quarterly update.** Exports are slowing, which could have spillovers to otherwise robust domestic demand. The region's strong fundamentals, room for policy maneuver, and demand from China and India should help limit these risks.

Index

Publication date: November 8, 2011

Summary

Asia's growth momentum has continued to moderate due to weakening external demand. In particular, GDP growth in the third quarter was weaker than expected, and more recently exports are showing signs of deteriorating. Strong domestic demand has partially offset the impact of the weaker external environment. But the rebound we had previously expected in the second half of the year—on Japan's recovery and lower commodity prices—has not taken place.

The moderation in growth has helped to ease overheating pressures and, barring a further deterioration in US and European growth prospects, Asia's growth outlook is still robust. Strong fundamentals, continued growth in China and India, and resilient domestic demand are helping to shield the region from the fallout of sluggish growth in the US and ongoing financial tensions in Europe.

In view of the weaker external demand outlook, we have revised down our 2011 and 2012 growth projections, but only modestly at this stage. For Asia ex-China, we have lowered our 2011 full-year growth projection from 4.1% to 3.7% on account of a weaker second half; and to 4.9% in 2012 from 5.2% previously. We have lowered our growth projections for China to 9.1% and 8.6% in 2011 and 2012, from 9.4% and 9.1% previously. Underlying the revisions is our baseline expectation of continued strength of domestic demand and a gradual rebound in external demand during the course of 2012, especially in the second half of the year.

Nevertheless, downside risks to the outlook have increased sharply. In particular, risks of a further intensification of the European debt crisis could have important spillovers through both lower external demand and tighter financial conditions. These would weigh on the region's export and investment prospects, resulting in significantly lower growth especially for the region's smaller and more open economies. In such a scenario, however, growth in the larger economies of Asia, especially in India, China, and Indonesia, should hold up reasonably well given their reliance on domestic demand. The latter two also have room for policy stimulus.

Inflation, which has been a predominant policy concern for much of this year, has begun to recede due to slowing growth and falling food and commodity prices. Inflation remains above target levels in some cases, especially in India, China, Hong Kong, Singapore, and Vietnam. Even in these cases, however, inflation is declining. In the meantime, asset price bubbles are an ongoing concern for property sectors in China and Hong Kong, where the authorities continue to enforce policies to slow the pace of further price increases.

The decline in inflation has allowed the focus of monetary policy to shift gradually toward support for growth. Australia and Indonesia have already begun to cut interest rates, Singapore recently eased its stance by reducing the slope of currency appreciation, and the Bank of Japan has intervened to stem the rise in the yen while also expanding its asset purchase program. Going forward, we expect some modest further policy easing in these economies. However, given the accommodative stance of existing policies in much of the region, we do not expect steep interest rate cuts, barring a significant deterioration in the external outlook.

Markets remain fixated on prospects of a resolution to the European sovereign and financial crisis. As a result, the outlook for currencies and equities in this environment is more uncertain than usual. Assuming a reduction in global risk aversion in our baseline, we would expect Asian currencies to remain on a modest appreciation trend. More generally, given the region's strong fundamentals and limited direct exposure to European sovereign debt, the outlook for markets is reasonably robust.

As noted above, risks have shifted to the downside since our last quarterly update. The predominant risk is from a deterioration in the European debt crisis. Beyond this, there is the possibility that weaker export growth could have spillovers to domestic demand, which would result in lower growth prospects than in our baseline. Offsetting these risks is the region's room for policy stimulus. In addition to monetary easing, most countries have room for supportive fiscal policy given their low deficit and debt levels, although implementing such policies quickly could prove challenging.

1. Global outlook: slowdown with risks tilted to the downside

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.

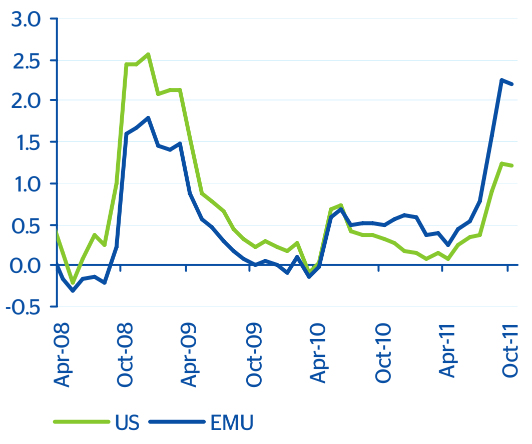
The outlook is heavily dependent on the resolution of the European debt crisis

The outlook for the global economy has worsened over the past few months, driven mainly by four factors whose influence is still being felt. First, lower than expected economic growth mainly, but not only, in developed economies. Although US growth increased in the third quarter, economic activity in Europe, which had held up in the first quarter, is now on a clear deceleration path. Second, the sovereign debt crisis in Europe has intensified and has become more systemic. While decisions announced in the October summit go in the right direction, key elements are still unresolved, especially regarding the firepower of mechanisms for providing sovereign liquidity--a leveraged European Financial Stability Fund (EFSF), the restructuring of Greek debt held by private investors, and a roadmap for advancing European governance towards a fiscal union. Third, the feedback between sovereign concerns and the health of the European financial system has intensified, with financial tensions exceeding the levels reached after the collapse of Lehman Brothers in October 2008 (Chart 1). Finally, higher global risk aversion has resulted in increased financial market volatility, spilling over to emerging market assets for the first time since 2009.

In this context, we revise downward our global growth forecasts by 0.3pp in 2011 and 2012, relative to our previous Global Economic Outlook, mostly due to lower expected growth in advanced economies (US and Europe, compensated in part by Japan), although emerging markets will also grow slightly less than previously anticipated. Thus, the global economy would grow by 3.9% in 2011 and 4.1% in 2012, supported by still-solid growth in emerging economies against lackluster performance in advanced countries (Chart 2).

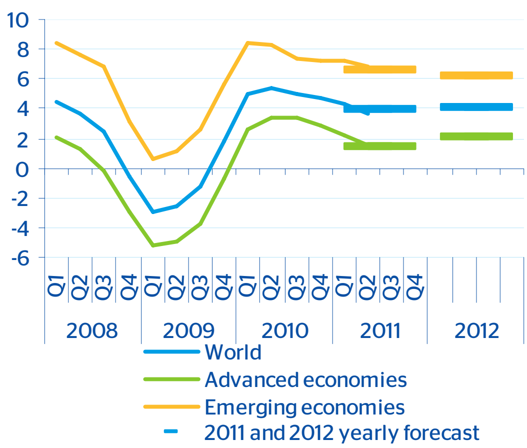
While these are still reasonably strong growth rates, risks are strongly tilted to the downside, hinging in the short term on the evolution of the sovereign-financial crisis in Europe. In particular, a quick reduction of financial stress in Europe is needed to avoid a sharp impact on growth both in Europe and in other regions through financial exposures and spillovers from global risk aversion.

Chart 1
BBVA Financial Stress Index



Source: BBVA Research

Chart 2
Global GDP growth (%yoy)



Source: IMF and BBVA Research

Europe takes steps in the right direction, but leaves key elements unresolved

In our view, there were five main points that needed to be successfully addressed in the October EU summits: (i) tackling the sustainability of Greek debt; (ii) erecting sovereign firewalls in the EMU; (iii) pushing for further reforms in peripheral countries; (iv) strengthening the banking sector; and (v) advancing euro area governance. In this regard, the recent summits have taken important steps in the right direction, but have not yet addressed most of these points definitively. First, private bondholders of Greek debt are asked to take a voluntary haircut of 50% –much higher than agreed in July– but doubts still linger about participation in the exchange and about the solvency of Greece, even with full participation. Second, the EFSF will be leveraged as an insurance mechanism and complemented with outside investors (including possibly the IMF), but it is unlikely that the specifics of the functioning of the EFSF will be in place before December. Many weeks will pass to ascertain its effectiveness, and hence the ECB will still be needed as a buyer-of-last-resort for sovereign debt, against the reticence of core European countries. Third, while it is welcome that more economic reforms are now on the agenda (notably in Italy), the recapitalization of the banking sector is being done inefficiently, posing risks of a sudden deleveraging of European banks. Also, a long-term liquidity provision mechanism is not in place yet. Finally, while there have been some advances in European governance, there is no clear roadmap to a fiscal union or Eurobonds, which in our view a key to a more credible monetary union in the long run.

As we have emphasized in the past, partial solutions may help prevent a further escalation of financial tensions, but not to reduce them to more sustainable levels. As such, the agreements reached so far still leave doubts about whether the necessary structure to prevent contagion from a Greek debt restructuring is in place. This would require a sufficiently large EFSF with the ECB as debt-buyer-of-last-resort and recapitalized banks with access to financing. Without these elements in place, markets will continue to discount the sustainability of reforms in Greece and appetite for further bailouts in core countries, increasing the probability of a downside scenario of a credit crunch and a recession in Europe, with global spillovers.[1]

Some improvements in US growth in Q3, but structural weaknesses remain

More on the positive side, growth in the US seems to have accelerated in the third quarter, at least according to preliminary estimates. This is not saying much –growth in the first two quarters was very low and the output gap is still very high. But it appears to have reduced market expectations of a double dip. Nevertheless, structural weakness remain in the US economy, as consumer and business confidence continue to be weak along with prospects of further housing market adjustments. This would imply lower resilience in the face of a possible shock from Europe. In addition, political deadlock could impede a "grand bargain" to (i) prevent an unintended fiscal contraction in the short run and (ii) push reforms towards a credible fiscal consolidation in the long run.

Emerging economies on track for a soft landing, but with external headwinds

Emerging economies continue growing strongly, supported by the resilience of domestic demand. Still high commodity prices for Latin America and export growth in Asia –despite strong corrections in both cases– also contribute to a strong growth outlook, which is on track for a much-awaited soft landing after concerns of overheating seen earlier in the year. Renewed turmoil in Europe and the US already represent strong headwinds from financial markets in both regions –reflected in increased market volatility, depreciated exchange rates and reduced capital inflows. However, many countries also enjoy sizable buffers –stronger public finances and better macroeconomic management than in the past– and are well positioned to introduce policy stimulus to counter weaker external demand. Overall, a more negative external environment has switched the focus in emerging countries from overheating to downside risks and, increasingly, the possible need for policy support.

[1] See "Channels of global contagion in the event of a disorderly default in Europe", Box 1 in the July 2011 Global Economic Outlook for an outline of the channels of transmission and global impact of a disorderly default in Europe.

2. A slowdown in Asia: healthy or worrisome?

The year 2011 began in Asia with concerns about economic overheating. But as the global outlook progressively deteriorated, and with signs of a slowdown within the region now becoming clearer, the policy focus has shifted to sustaining growth.

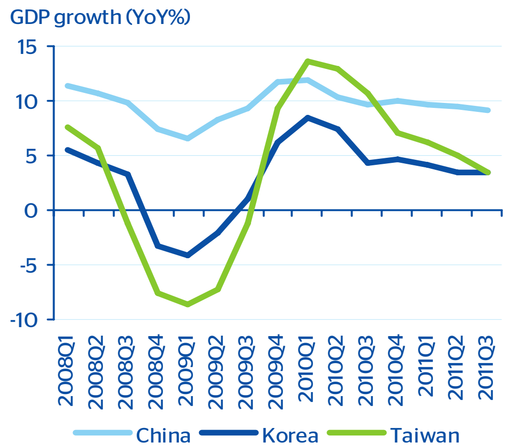
After a strong first quarter in which GDP outturns across Asia surprised to the upside, momentum began to moderate in the second quarter. As readers of our previous Outlooks will recall, the moderation was in line with expectations and had been anticipated due to supply disruptions from the March earthquake in Japan and headwinds from high commodity prices. Growth nevertheless remained strong through the first half of the year, propelled by robust domestic demand. As such, the slowdown was healthy, in that it helped take off some of the overheating pressures that had been building.

As flagged in our previous Asia Outlook, a rebound was expected in the second half of the year as Japan recovered and as commodity prices eased. Due mainly to the weaker-than-expected external environment, however, that rebound is not taking place. In particular, recent activity indicators point to softening external demand, particularly for the region's smaller and more open economies. Accordingly, we are revising down our growth projections for the remainder of 2011 and 2012, but only modestly given still-strong domestic demand that has so far partially offset weaker external demand. With external demand weakening and inflation beginning to decline, policymakers have shifted their focus to supporting growth.

In many respects the ongoing slowdown remains healthy, as overheating pressures have eased further, and inflation appears to have peaked. Sentiment around Asia remains high due to the region's strong fundamentals (see Box on pages 13-14 on, How well can Asia withstand an external shock?). Core inflation remains on the high side in some economies, such as Korea (3.7% y/y in October), posing a dilemma for policymakers as they shift towards more accommodative policy stances. To date, Indonesia and Australia have eased interest rates, with most other central banks having shifted to pause. India is the most recent to have raised rates (to 8.5% in October), as it copes with high inflation, of above 9% y/y throughout the year so far.

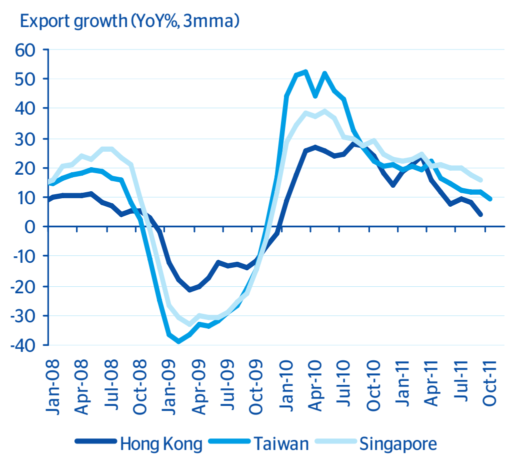
As global players became increasingly risk averse during the summer, market volatility reached levels not seen since the Lehman crisis as investors indiscriminately sold Asian equities, bonds and most Asian currencies (with the exception of the yen) towards the end of the third quarter. Asia's sovereign CDS spreads increased appreciably, as investors bought hedges against their long positions. While sentiment remains tenuous, there has been a partial rebound in the markets as signs of a resolution to the European debt crisis begin to emerge.

Chart 3
Asian growth continued to moderate in Q3...



Source: CEC and BBVA Research

Chart 4
...with export growth falling on external headwinds



Source: CEIC and BBVA Research

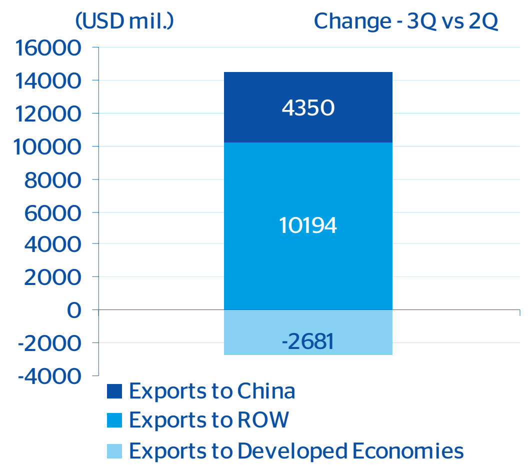
Moderating third quarter activity from external headwinds

Global headwinds have had an effect on Asia's third quarter GDP outturns. In particular, China (9.1% y/y), Korea (3.4% y/y), and Taiwan (3.4% y/y) have all seen a further moderation from the second quarter (Chart 3), and export growth has slowed, particularly in the smaller and more open economies such as Singapore, Hong Kong, and Taiwan (Chart 4). Sequential GDP trends also show a slowdown in Korea (0.7% q/q in Q3 from 0.9% in Q2), and Taiwan, where the economy contracted for the first time since 2009 (-0.3% q/q in Q3 from 0.2% in Q2). Sequential GDP growth rebounded in Singapore (1.3% q/q, saar in Q3 from -6.5% in Q2), thus avoiding a technical recession; nevertheless, signs of a further moderation are evident, and the Monetary Authority of Singapore recently revised downwards its full-year 2011 GDP forecast to the bottom of its previous 5-6% forecast range.

That said, GDP growth has not collapsed and has held up in some cases – Indonesia, for example, reported 6.5% y/y growth in Q3 broadly unchanged from the previous quarter. More generally, strong domestic demand has provided offsetting support, and exports, though weakening, have proved resilient, including in Korea and Indonesia, due to strong intraregional trade, demand from other emerging markets, and the ongoing reconstruction efforts in Japan. Continued strong growth in China in particular has facilitated an expansion of intraregional trade which has helped to buoy exports from elsewhere in the region (Chart 5).

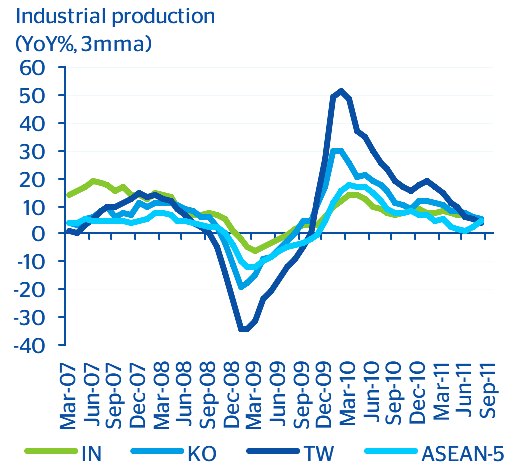
However, in the coming quarters weaker external demand stemming from events in the US and Europe could well lead to a further slowdown in exports, with spillovers to domestic demand in the smaller, more open Asian economies. Taiwan, for example, whose trade with the US and Europe accounts for almost 20% of its exports, has already experienced a sharp decline in exports – overall exports contracted by 7.9% q/q on a seasonally adjusted annualized basis in Q3. Hong Kong's exports also weakened sharply: while q/q growth was 5.2%, year-over-year growth fell to minus 3.0% in September, as trade with the US contracted by 8.9% y/y for the month, and on a sequential basis, Hong Kong's exports decreased by 10% in September, seasonally adjusted, after gaining 1.5% m/m in August.

Chart 5
The change in selected countries' exports to key markets



Note: Countries whose exports are represented above include Korea, Singapore, Taiwan, and Thailand; Developed economies includes France, Germany, Italy, Japan, UK, and the US.
Source Haver Analytics and BBVA Research

Chart 6
Industrial production growth continues to slow



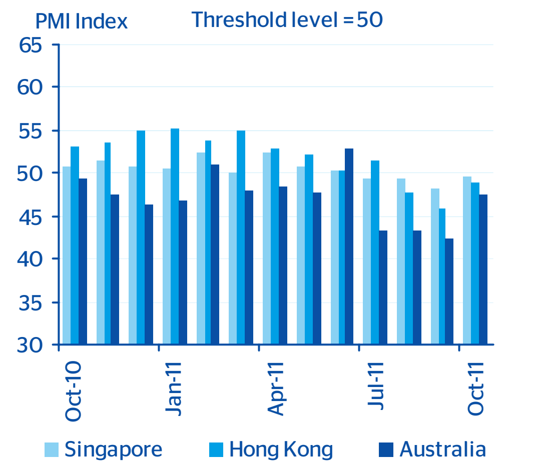
Source: CEIC and BBVA Research

Besides exports, other high frequency indicators showed signs of weakening in the third quarter. Industrial production has continued to moderate, particularly in India, Korea and Taiwan (Chart 6). Indian industrial production was driven lower by a contraction in mining activity and a slowing manufacturing sector. While China's PMI has been resilient, remaining above the critical 50+ expansion level, it too has been moderating, and PMI's in other Asian economies, including Australia, Hong Kong, and Singapore have dipped below 50 (Chart 7).

Robust domestic demand has helped support overall GDP growth despite the weakening external environment. This is especially true for the larger economies, including China, India, and

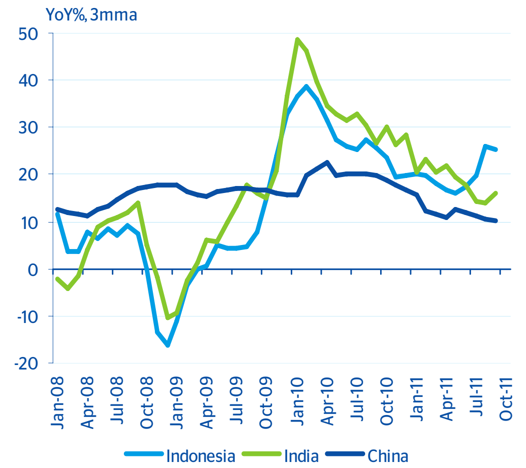
Indonesia where retail sales growth has remained strong (Chart 8), and in Korea, where domestic demand accounted for over half of quarterly GDP growth in Q3. Domestic demand, in turn, has been supported by rising wages and low unemployment (Charts 9 & 10), as well as continued rapid credit growth (Chart 11). The latter, however, has generated its own set of concerns, leading the authorities in China and India in recent quarters to manage lax liquidity conditions by raising reserve requirements and hiking interest rates (though China has been on pause since July, India hiked rates as recently as October); the authorities in Hong Kong continue to monitor rapid credit expansion for signs of weakening credit quality. Nevertheless, Asian banks remain well-capitalized and appear well-positioned to weather the current global turmoil (see Box on page 13).

Chart 7
PMIs have declined on global uncertainties



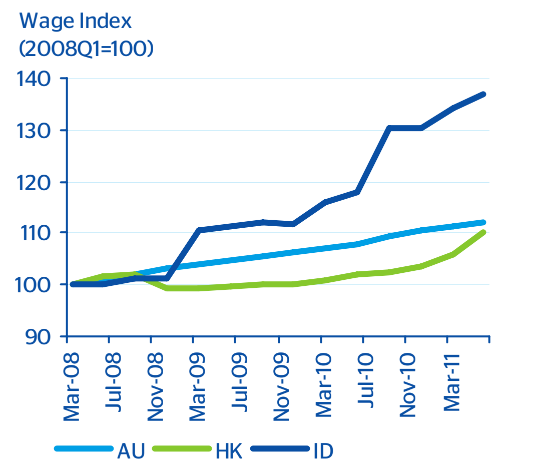
Source: CEIC and BBVA Research

Chart 8
Retail sales growth remains quite healthy...



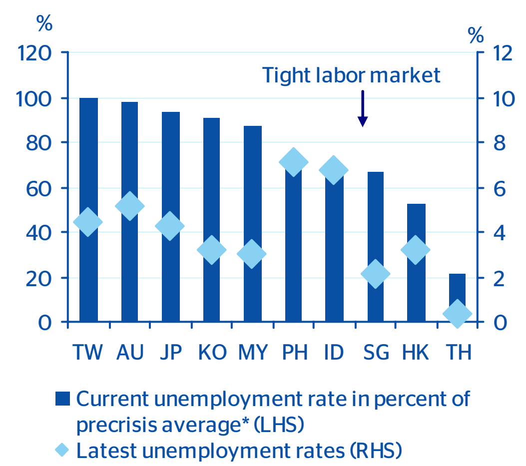
Source: CEIC and BBVA Research

Chart 9
... as wages continue to rise



Source: CEIC and BBVA Research

Chart 10
Low unemployment...



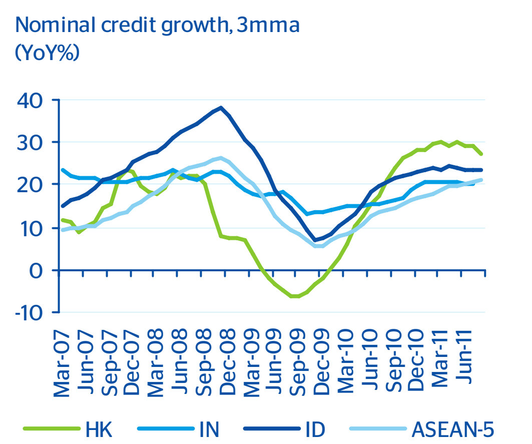
* Note: Average unemployment from 2002-2007
Source: CEIC and BBVA Research

Japan's economic recovery continues to advance from the disruptions of the March 11 earthquake and tsunami, with exports and output returning to their pre-quake levels. However, the recovery remains tepid, and the Bank of Japan has expanded its balance sheet and has intervened to counter a strengthening yen which has been undermining growth prospects. Supply chain disruptions from the ongoing floods in Thailand have placed further pressure on Japanese producers.

Korea remains on track for a soft-landing after GDP growth rose by 3.4% y/y in the third quarter. Exports held up reasonably well (Chart 12) before showing signs of weakening in October

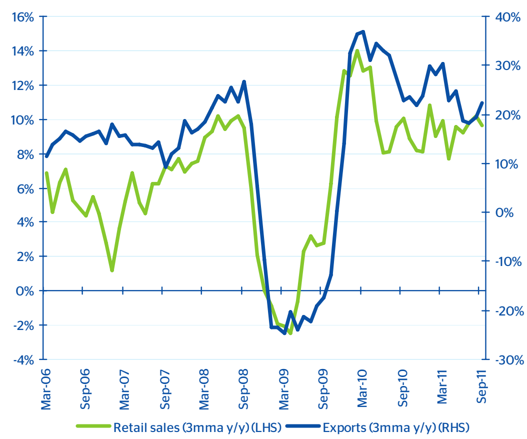
(9.3% y/y, the slowest pace since 2009). Domestic demand firmed in the third quarter, supported by strong credit growth, helping to sustain overall GDP growth. In India, growth has slowed on weakening investment due to headwinds from higher interest rates and perceptions of slowing economic reforms.

Chart 11
....and fast credit growth boost domestic demand



Source: CEIC and BBVA Research

Chart 12
Korea's easing indicators point to a soft landing



Source: Haver Analytics and BBVA Research

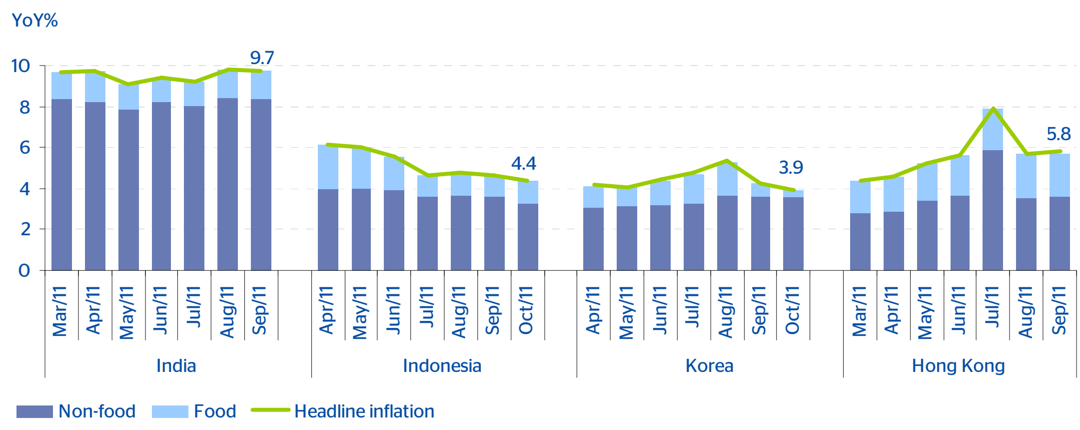
Inflation appears to have peaked, but remains on the high side

Inflation has been moderating after peaking in the third quarter (Chart 13) due to easing food and commodity prices (Charts 14 & 15). The decline has been evident in both year-on-year and sequential terms, such as in Indonesia where m/m inflation turned negative, to -0.1% in October, after +0.3% in September, and Australia (0.4% q/q, s.a. in Q3, after 0.7% in Q2).

Nevertheless, it is too early to declare an end to the battle with inflation, which remains at or above target ranges in many cases, such as in Singapore (5.5% y/y vs. target 4-5%) and Korea (3.9% y/y, target 2-4%). Additionally, core inflation remains elevated (Chart 16). Inflation has been especially stubborn in India due to a combination of still-strong demand pressures and a weakening rupee.

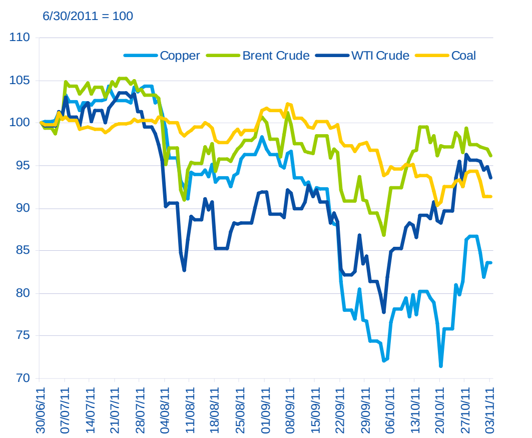
Vietnam continues to struggle with the highest inflation in emerging Asia, accelerating to 22% y/y in July due to overheating pressures and currency depreciation. On the other end of the spectrum is Taiwan (1.2% y/y in October), where the central bank's firm grip on monetary policy and stable food prices have helped keep inflation at the lowest level in emerging Asia.

Chart 13
Headline inflation appears to be falling as the global economy slows



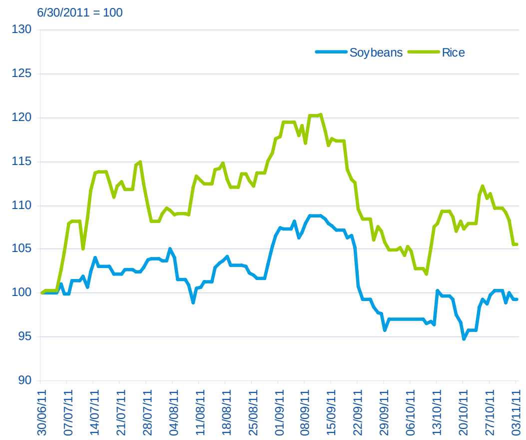
Source: CEIC and BBVA Research

Chart 14
Commodity prices are falling due to the slowdown



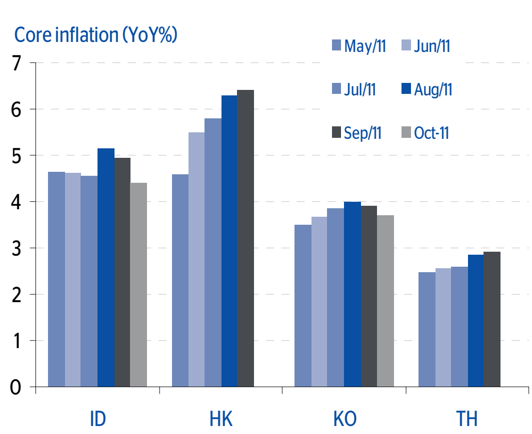
Source: Bloomberg, CEIC and BBVA Research

Chart 15
Food prices appear to have peaked for now...



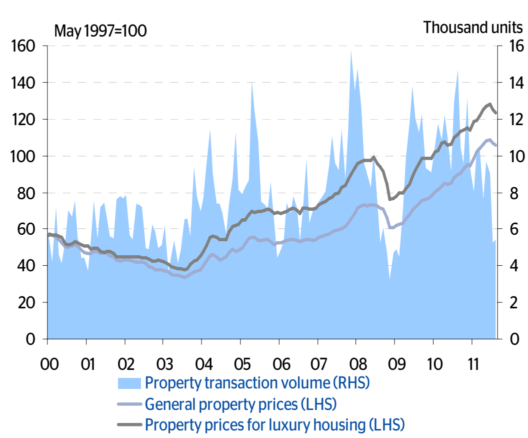
Source: Bloomberg, CEIC and BBVA Research

Chart 16
...but core inflation is still elevated



Source: CEIC and BBVA Research

Chart 17
Hong Kong's high housing prices are now easing



Source: CEIC and BBVA Research

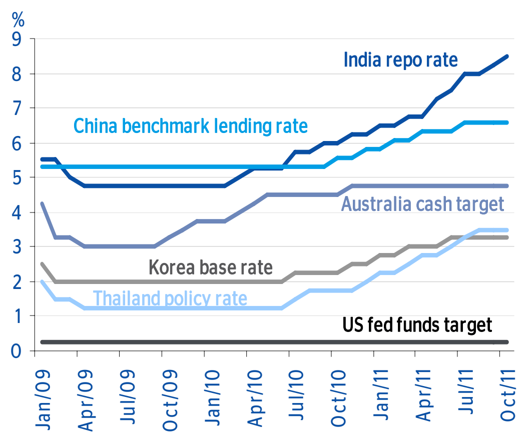
In Hong Kong, where rising rents have contributed to elevated headline inflation (residential rents account for 31% of the consumer price basket), the authorities have taken a series of measures to cool the property sector. As a result of these steps and ongoing global risk aversion, property prices and transactions volumes have begun to ease (Chart 17). In its annual policy address in October the government announced a resumption of its Home Ownership Scheme (HOS) to provide subsidized housing and plans in the coming years to construct more affordable housing and increase the supply of land.

Policy focus shifts from taming inflation to supporting growth

As a result of global uncertainties and slowing growth and inflation, policymakers in the region have begun to shift their focus to support for growth. Interest rate hikes have been put on hold for the most part, with outright easing having already begun in Indonesia (October) and Australia (November) (Chart 18), and various forms of a relaxation in the monetary stance in Singapore (in October, with a slowing in the pace of appreciation), China, and Japan. Somewhat out of step with these trends, India raised rates for a 13^{th} consecutive time in October in view of its high inflation, but signalled that this would likely be the last such move in the current tightening cycle. The decision to shift to easing interest rates, however, has been cautious given still-high inflation in some cases, and accommodative monetary stances, in which real rates remain close to zero (Chart 19).

Chart 18

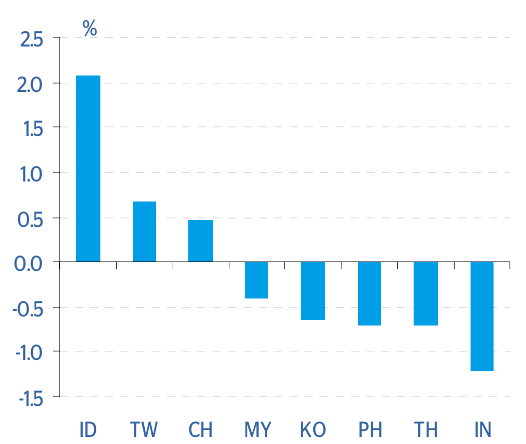
Most central banks have put tightening on hold...



Source: CEIC and BBVA Research

Chart 19

...but negative real rates prevail in some cases



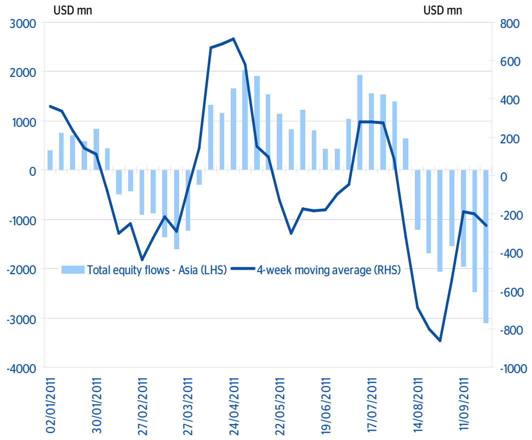
Source: Bloomberg, CEIC and BBVA Research

Asian markets fall on increased global risk aversion

Uncertainties about the US and European outlooks have dominated market sentiment, with periodic waves of sell-offs of "high risk" equities, currencies and bonds, such as occurred at the end of September (Chart 20 and 23). Portfolio outflows increased, as investors focused less on the region's strong fundamentals in favor of global trends and the need to raise liquidity in anticipation of redemption needs. These abrupt capital outflows caused some central banks to intervene in FX markets, such as Bank Indonesia, which used some of its reserves to smooth volatility. For its part, in late October, Japan intervened for a fourth time since September 2010 to counter appreciation pressures, which have occurred given the yen's safe haven characteristics. Central banks' reserves management has also been challenged following S&P's sovereign downgrade of the US, which has led to diversification away from US dollar holdings, although the region continues to be heavily invested in US Treasuries (Chart 21).

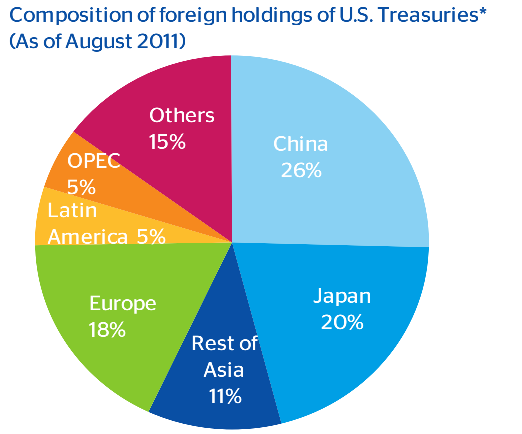
Despite the recent sell-off, Asian currencies have been among the favorites of international investors for most of the year, with many currencies reaching multiyear highs due to the region's strong fundamentals. That said, bouts of asset selloffs have led to currency volatility and weakness against the USD in the second half of the year (Chart 22). As an example, the Australian dollar reached an all-time high of 1.1081 versus the USD on July 27, only to plummet to 0.9662/USD by the end of September. Movements in the Australian dollar remain subject to shifts in perceptions about commodity prices, the strength of China's demand, and the outlook for domestic interest rates.

Chart 20
Global uncertainties have led to increasing equity outflows



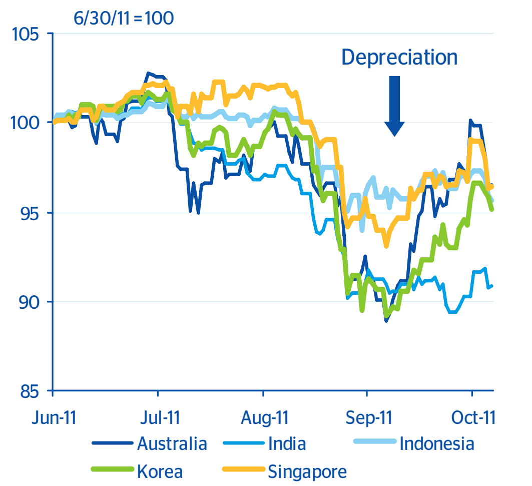
Note: Markets represented include India, Indonesia, Korea, Philippines, Taiwan, Thailand, Vietnam
Source: EPFR, Bloomberg and BBVA Research

Chart 21
Asia accounts for the bulk of foreign holdings of US treasuries



Note: Foreign holdings represent around 30% of total outstanding US Treasuries
Source: US Department of the Treasury and BBVA Research

Chart 22
Asian currencies weakened in the third quarter



Source: Bloomberg and BBVA Research

Chart 23
Asian CDS prices show heightened risk aversion

Source: Bloomberg and BBVA Research

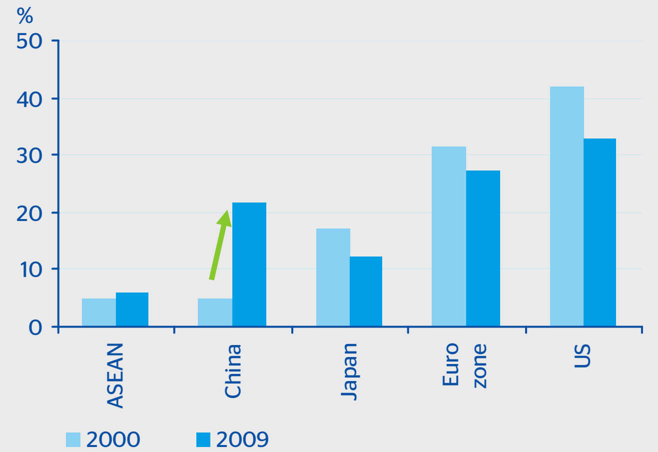
Box: How well can Asia withstand an external shock?

Global markets have been buffeted recently by concerns about the European debt crisis and sluggish growth in the US. Capital outflows from "risky" assets in emerging markets, including Asia, accelerated in August and September. Markets in Asia have stabilized recently as European leaders focus on plans to limit contagion risks and resolve the crisis. A flow of positive data from the US has also helped.

With markets still tense, and with downside risks to the outlook increasing, however, it is important to assess Asia's resilience to external shocks. The region is heavily dependent on exports and its capital markets are highly integrated with global markets. As a result, the region would be exposed in the event of a severe global downturn—as it was post-Lehman—but its vulnerability has decreased over time, and in our baseline of sluggish global growth, the region should be well-placed to sustain reasonably healthy growth.

Chart 24

Asian export market shares based on final demand



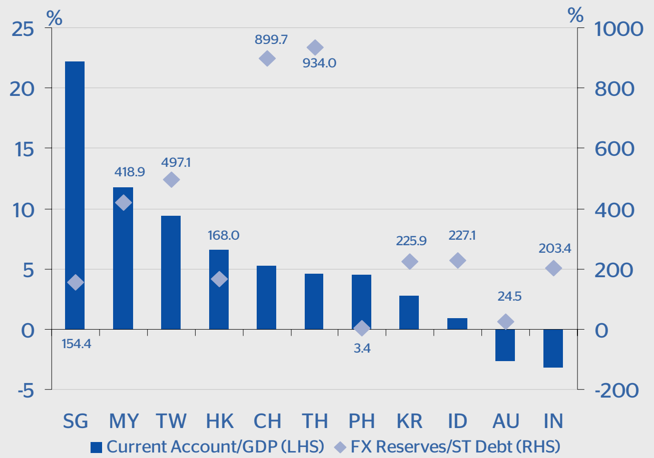
Source:: IMF, Singapore MAS and BBVA Research

Under our baseline scenario of weak external demand, Asia's exports are likely to slow further over the next two quarters, as around 60% of final demand for Asian goods exports still comes from the US and Europe (Chart 24), based on estimates from the IMF and the Monetary Authority of Singapore, and supported by similar analyses by the Asian Development Bank. However, around a third of final demand for Asian exports comes from within the region itself, a share that has risen over time, due largely to rising final demand from China. This should help blunt the impact of a slowdown compared to what would have been the case a decade ago.

Further, strong regional fundamentals, including low debt-to-GDP ratios and low fiscal deficits, should provide support to Asia in a slowdown environment. Positive current account balances (other than India) and high foreign reserve levels (Chart 25), would also be a comfort in the event of a sudden stoppage of capital flows.

Chart 25

Asia has strong current account and reserve positions

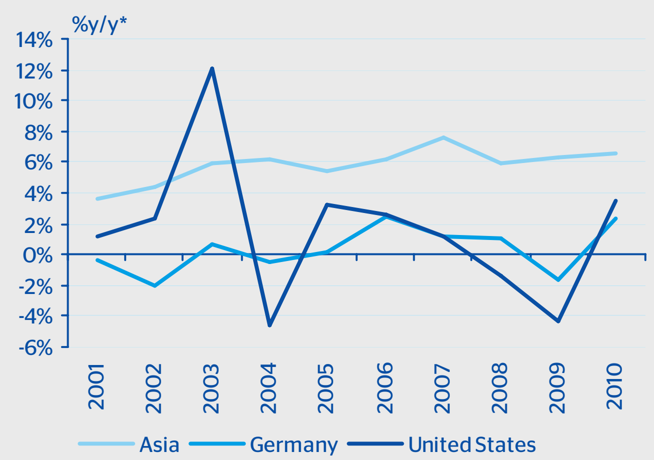


Source: IMF, Haver Analytics and BBVA Research. Current account data is from 2010 .

There is also room for policy stimulus. Some countries have moved in this direction already, with Australia, Indonesia, Japan, and Singapore easing monetary policies, and the Philippines increasing fiscal spending to combat the slowdown in exports. Such policies should help sustain domestic demand, which has grown steadily over the past decade, outpacing that of advanced economies (Chart 26).

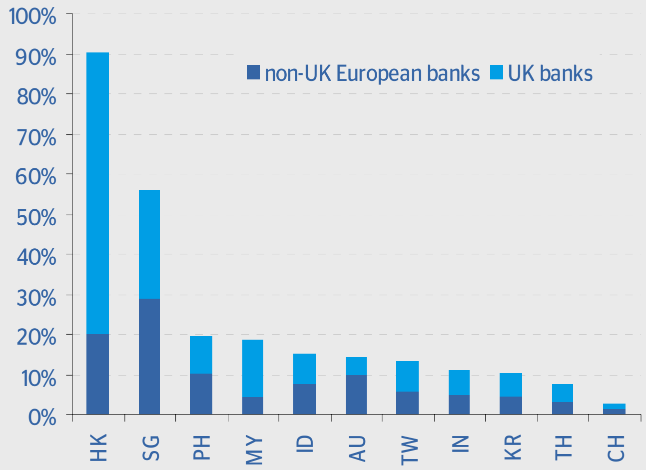
Chart 26

Asia's domestic demand has grown steadily in the last decade



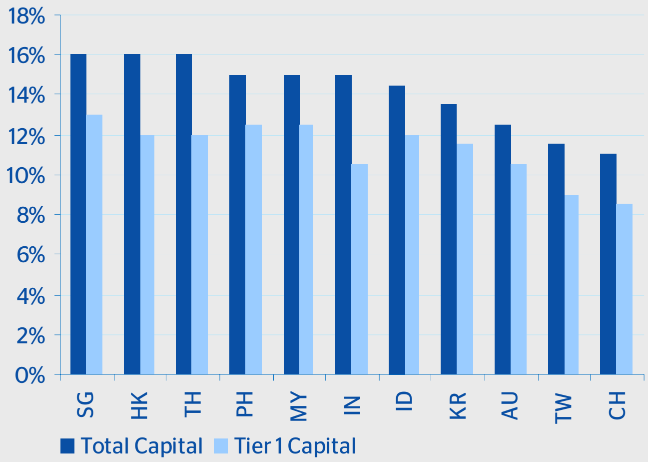
* Note: Designates growth in private consumption, government consumption and investment. Source: CEIC and BBVA Research

Chart 27
Asia borrowing from European banks as % of domestic credit



Source: CEIC, BIS and BBVA Research

Chart 28
Total and tier 1 capital – Asian banks



Source: Fitch and BBVA Research

Beyond a still-heavy reliance on exports, one area of vulnerability in the context of a tightening of external credit conditions is Asia's reliance on external borrowing, including from Europe (Chart 27). Nevertheless, even in a scenario in which foreign banks were to curtail lending, Asian domestic banks would appear well placed to provide credit in their place to domestic borrowers; use of ample central bank foreign exchange reserves should also help alleviate shortages of foreign currency liquidity. Banks across the region are well capitalized (Chart 28), which should serve as a buffer to external shocks.

Cautious Outlook

Asia would be far from immune to the spillovers emanating from abroad in the event of an abrupt slowdown. As was the case post-Lehman, the smaller and more open economies would be more vulnerable given their reliance on external demand and external capital flows. Korea and Indonesia remain vulnerable to swings in global capital markets, and India, given its twin deficits (current account and fiscal) would be susceptible to a global downturn. However, the point remains that the region's strong fundamentals and growing intraregional trade should help the region to cope with the fallout of a global slowdown.

3. Modest downward revisions to 2011, 2012 growth projections

With lower growth expected in Europe and the US under our global baseline, we have marked down our 2011 and 2012 growth projections for Asia. The region should continue to benefit from strong underlying fundamentals over the medium-term, but risks are clearly skewed towards the downside, as domestic demand is slowing and exports are weakening. Therefore, the rebound we had previously expected to take place during the second half of 2011 has been delayed to at least the second quarter of 2012. With growth slowing and with commodity and food prices continuing to ease, headline inflation should also ease further. In our baseline, we are now expecting growth to bottom in the second quarter of next year, before rebounding strongly during the second half of the year.

Weak external environment results in lower GDP estimates for 2011, 2012

With external headwinds now much greater than in our previous Asia Outlook, we have made revisions to our projections for GDP growth in 2011 and 2012 (Table 1). We have revised down our 2011 GDP forecast for Asia Pacific to 5.9% y/y (from 6.2%), and 2012 to 6.4% (from 6.7%). The major revisions include our China forecasts, which have been adjusted downwards to 9.1% y/y and 8.6% y/y for 2011 and 2012, respectively (from 9.4% and 9.1% previously). We also project growth in Singapore of 5.1% y/y and 4.1% y/y in 2011 and 2012 (down from 6.0% and 4.8% previously), and our projections for Australia have been revised downwards, to 1.8% y/y in 2011 (from 2.3%) and 3.6% in 2012 (from 3.8%). Due to the recent floods, in Thailand we have revised our GDP forecast to 3.0% this year (from 4.0%), although the impact is still being assessed. Growth for Asia ex-China is forecast to be 3.7% this year (from 4.1%) and 4.9% next year (from 5.2%).

As such, our growth projections remain broadly healthy, despite being marked down from our previous outlook. Nevertheless, the projections are subject to downside risks given the uncertain global environment.

Inflationary pressures to ease gradually

Inflation should continue to ease across the region (Table 2) due to easing demand pressures and falling food and commodity prices. Forecasts for average inflation in 2012 in Singapore (3.5% y/y), Hong Kong (4.5% y/y), Australia (2.9% y/y) and Korea (3.4% y/y) should come down in line with official target ranges, after exceeding comfort levels for much of 2011. However, inflation is still elevated in some countries, and ongoing assessments will be needed.

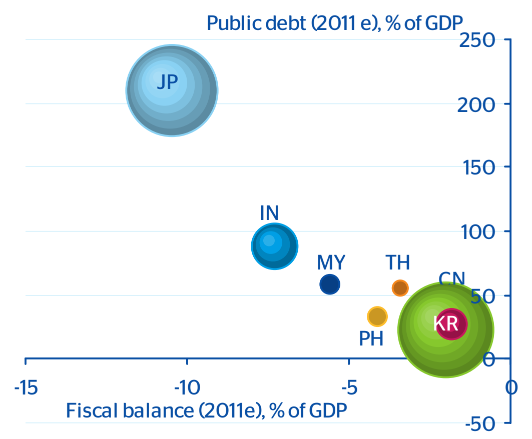
Policymakers may shift from wait-and-see to easing mode

For most countries, monetary policy will likely remain on hold for the time being (Table 4), as policymakers remain wary of inflation, despite recent signs of easing. As noted above, Indonesia, Australia, and Singapore have already taken steps toward easing, and we anticipate further modest rate cuts in the former two in the coming quarters. In China, selective forms of easing may take place before the end of the year, possibly in the form of cuts in reserve requirements for small banks. While aggressive rate cuts are not in our current baseline for any of the countries – monetary stances are already quite accommodative – there would be room for further easing if weaker external demand conditions and easing inflation were to warrant them.

With debt and deficit levels quite low for the most part, there is also room for fiscal stimulus if needed to support growth in the event that downside risks materialize (Chart 29). Recent fiscal stances have continued to scale back the stimulus measures incurred during the 2008-09 financial crisis (Chart 30). Additional stimulus measures would most likely focus on infrastructure spending, and policies to encourage greater consumer spending, especially in China where there is wide scope to raise consumption levels. Indeed, the Philippines government has already moved in this direction by unveiling a stimulus package in late October geared towards infrastructure projects.

Chart 29

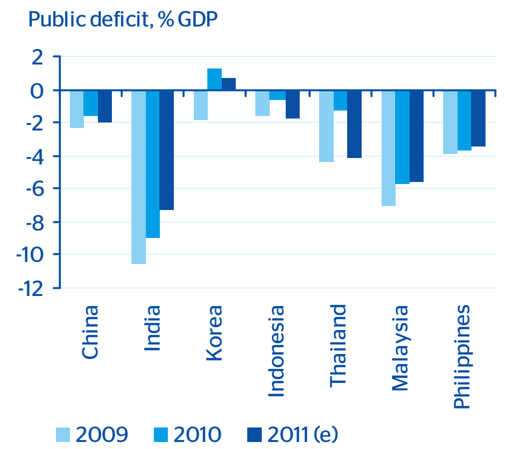
Most countries have room for stimulus if necessary



Source: CEIC and BBVA Research

Chart 30

Fiscal deficits have declined after the crisis



Source: CEIC and BBVA Research

Currencies: regional strength, but Europe still casts a shadow

Overall, given Asia's relatively strong growth prospects and positive interest rate differentials, the region's currencies are well-positioned to continue their rebound (Table 3). However, the outlook remains subject to developments in global risk aversion, which in turn hinge on a satisfactory resolution to Europe's debt and financial problems. As such, there are downside risks to the outlook, and currencies would be subject to significant weakening in the event of a more pronounced global slowdown which would weigh on export performance.

4. Downside risks to the outlook

A worsening global environment poses downside risks to our growth projections. With growth moderating further and inflation now easing, overheating risks have faded. If global growth were to slow beyond our current baseline, and if financial tensions were to increase, the fallout in Asia would be more severe than in our current projections. The region's smaller and more export-oriented economies would feel the largest growth impacts. Meanwhile, economies with open capital accounts and dependence on foreign borrowing, such as Korea, Indonesia, and Australia, would be relatively exposed to an abrupt stoppage in international capital flows. That said, the region's strong underlying fundamentals, which include high foreign exchange levels, well capitalized banking systems, and room for policy stimulus, should help counter these risks.

Even under our current baseline, there is a risk that domestic demand may not hold up as expected. This is especially true of the more export-oriented economies, which could see spillovers to domestic demand from slowing export growth. The region's larger economies, including China, India, and Indonesia, are relatively better positioned to sustain strong domestic demand.

Country specific risks arise from rapid credit growth in Hong Kong, which has exacerbated the possibility of asset bubbles in the property sector and future non-performing loans, although these risks are now receding. India is still coping with high inflation, and the presence of large fiscal and current account deficits leave it relatively more vulnerable to external shocks. In Japan there is a risk that the post-earthquake recovery could falter, especially if the yen remains strong. Korea and Taiwan hold presidential elections in 2012 (Taiwan in January, and Korea in December), that will be closely monitored for possible policy shifts.

Other than the possibility of a more severe global downturn, the largest risk facing the region is the associated possibility of a hard landing in China. Nevertheless, we view such risks as low probability, as detailed in our forthcoming China Outlook. Room for policy stimulus and the still manageable size of local government debt and shadow bank lending should enable the authorities to engineer a soft landing. Nevertheless, the risks cannot be dismissed and a close monitoring will be required.

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	1.6	2.3
EMU	0.3	-4.1	1.7	1.7	1.0
Asia-Pacific	5.2	4.1	8.0	5.9	6.4
Australia	2.4	1.4	2.5	1.8	3.6
Japan	-1.2	-6.3	4.0	-0.4	2.7
China	9.6	9.2	10.3	9.1	8.6
Hong Kong	2.3	-2.7	7.0	4.8	4.1
India	7.5	7.0	8.9	7.6	8.0
Indonesia	6.0	4.6	6.1	6.3	6.4
Korea	2.3	0.3	6.2	3.7	3.8
Malaysia	4.8	-1.6	7.2	4.5	4.9
Philippines	4.2	1.1	7.6	4.5	4.9
Singapore	1.5	-0.8	14.5	5.1	4.1
Taiwan	0.7	-1.9	10.9	4.5	4.2
Thailand	2.5	-2.3	7.8	3.0	5.3
Vietnam	6.3	5.3	6.8	6.2	6.5
Asia ex China	2.3	0.8	6.5	3.7	4.9
World	2.8	-0.7	5.0	3.9	4.1

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	2.9	2.2
EMU	3.3	0.3	1.7	2.6	1.6
Asia-Pacific	5.7	0.3	2.7	4.8	3.7
Australia	4.4	1.8	2.8	3.5	2.9
Japan	1.4	-1.4	-0.7	-0.2	-0.1
China	6.0	-0.8	1.2	5.3	3.9
Hong Kong	4.3	0.6	2.3	5.3	4.5
India	8.7	2.4	9.6	9.3	7.0
Indonesia	9.9	4.8	5.1	5.4	5.5
Korea	4.7	2.8	3.0	4.4	3.4
Malaysia	5.4	0.6	1.7	3.1	2.7
Philippines	9.3	3.2	3.8	4.5	4.0
Singapore	6.6	0.6	2.8	5.0	3.5
Taiwan	3.5	-0.9	1.0	1.5	1.4
Thailand	5.5	-0.8	3.3	4.0	3.8
Vietnam	23.2	6.9	10.0	19.0	13.3
Asia ex China	5.5	1.1	3.7	4.4	3.5
World	6.1	2.2	3.0	5.0	4.0

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	0.71	0.74
EMU	USD/EUR	1.50	1.40	1.34	1.40	1.35
Australia	USD/AUD	0.67	0.90	1.02	1.03	1.05
Japan	JPY/USD	96.1	92.1	81.1	77.0	84.0
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	49.0	45.0
Indonesia	IDR/USD	10838	9395	8996	8800	8700
Korea	KRW/USD	1364	1166	1126	1080	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	1.27	1.22
Taiwan	NTD/USD	33.0	32.3	29.3	29.5	29.0
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	0.25
EMU	2.73	1.00	1.00	1.00	1.00
Australia	4.25	3.75	4.75	4.50	4.75
Japan	0.10	0.10	0.10	0.10	0.10
China	5.31	5.31	5.81	6.56	6.81
Hong Kong	0.50	0.50	0.50	0.50	0.50
India	6.50	4.75	6.25	8.50	7.50
Indonesia	9.25	6.50	6.50	6.25	6.50
Korea	3.00	2.00	2.50	3.25	3.50
Malaysia	3.25	2.00	2.75	3.00	3.00
Philippines	5.90	4.00	4.00	4.50	5.00
Singapore	1.00	0.69	0.48	0.45	1.45
Taiwan	2.000	1.250	1.625	1.875	2.125
Thailand	2.75	1.25	2.00	3.25	3.00
Vietnam	8.50	8.00	9.00	11.00	9.00

Source: CEIC and BBVA Research

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