BBVA | RESEARCH

Economic Outlook

Asia

Second Quarter 2012
Economic Analysis

- **The outlook for the global economy is for a gradual recovery in 2012**. Risks to the outlook, however, are strongly tilted to the downside as the European crisis continues.
- **Consistent with this outlook, and with support from accommodative policies, growth in Asia is expected to pick up during the remainder of 2012.** There are already some tentative signs this may be occurring, although caution is in order given renewed external headwinds.
- **Nevertheless, we are revising down our full-year growth projections slightly for 2012 on the impact of higher oil prices.** With inflation moderating, there is scope for some further monetary policy easing in the period ahead to support growth.
- **Risks to the Asia outlook remain tilted to the downside due to ongoing uncertainties in the global environment.** A resumption of the European crisis is the predominant risk, with possible further increases in oil prices from tensions in the Middle East a secondary risk.

Index

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Summary

Asian growth has been slowing due to the weak external environment. Nevertheless, recent indicators suggest that growth may be in the process of bottoming out. This should set the stage for a pickup during the remainder of the year, although caution is in order given renewed external headwinds.

As growth continued to slow during the fourth quarter, full-year outturns for 2011 were broadly in line with projections. Growth outturns in the first quarter of this year show some sequential improvement, perhaps due to the rebound from last year's natural disasters in Japan and Thailand which caused major supply chain disruptions. While Q1 growth in China was lower than expected, we believe that momentum there has already bottomed out.

Inflation has continued to moderate, allowing scope for some further easing of monetary policy to support growth. While inflation remains elevated in a few countries, especially India, Hong Kong, and Singapore, for the most part inflation rates have fallen to within policymakers' target ranges. However, higher oil prices have been putting modest upward pressure on inflation, a risk that will need to be monitored if tensions in the Middle East were to intensify. At the same time, an eventual upturn in global risk appetite, combined with lax monetary conditions in advanced economies, could lead to capital inflows in Asia and upward pressure on asset prices.

We have made slight downward revisions to our 2012 growth projections due mainly to the impact of higher oil prices under our baseline scenario (15 percent higher than our previous quarterly scenario last February). The revisions, however, are quite modest, resulting in a lowering of growth for the Asia-Pacific region to 5.7% y/y for 2012 (just 0.1% lower than previously). Within these revisions are somewhat larger downward adjustments to our forecasts for India and Japan. Meanwhile, our outlook for China remains unchanged at 8.3% for 2012.

Risks remain firmly to the downside due to ongoing uncertainties in the external outlook, especially for Europe. While Asia has so far been resilient to the fallout of the European crisis – with demand from China and the US helping to offset weaker exports to Europe – an intensification of financial tensions and sharper declines in external demand could have detrimental effects on Asia's growth outlook through both trade and financial channels. Even under our current baseline of improving global growth, there is a risk that sluggish export growth could spill over to domestic demand.

Policy stances are expected to remain accommodative, and there is room for further easing in most countries if risks to the outlook materialize. While monetary policy easing has come to an end in parts of the region, some further loosening is expected in a number of countries to support domestic demand, particularly in China, India, and Australia. Meanwhile, fiscal policy stances also remain growth supportive in most countries, with emphasis on social spending and infrastructure. Fiscal circumstances are varied, however: Korea is front loading spending while maintaining its previous full-year deficit target, Australia is aiming to return to budget surplus, and Japan and India are trying to rein in their deficits to contain high levels of public debt.

The outlook for financial markets across the region remains heavily dependent upon the evolution of global risk appetite. After a rally early in the year, sentiment has turned more subdued of late due to rising financial tensions in Europe. While currencies may see some downward pressures in the near term, they are expected to appreciate later in the year as capital inflows resume. Overall, a combination of improving global growth under our baseline and continued lax monetary policies in advanced economies should set the stage for upward moves in asset prices during the course of the year.

1. Summary: global recovery, but risks reignite

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

Global economic activity will gradually recover, with wider regional growth differentials and risks tilted to the downside

After a gradual deceleration in 2011, particularly in the last quarter, the global economy is starting to show signs of increased dynamism. Global growth in 2012Q1 is expected to have been higher than in Q4, given stronger growth in Asia ex-China (including Japan) and Latin America, and sustained – but modest – dynamism in the US. We estimate that global growth will continue increasing and surpass 1% quarter-on-quarter at the end of 2012 (0.6% in 2011Q4). This recovery will be heterogeneous, with widening growth differentials between key economic areas.

The increase in growth will be more evident in Asia, as described below, given the rebound from natural disasters in Thailand and Japan (which had negatively affected regional supply chains) and some reversal of policy tightening measures implemented through mid-2011. Also, growth in Latin America is likely to pick up on easier monetary policy in Brazil and sustained growth in Mexico, helped by US demand. The US will continue sustaining quarterly growth rates of around 0.6% in 2012 and 2013, significantly lower than in previous recoveries. However, this will be a relatively strong performance compared to stagnant activity in the euro-area in 2012, with growth dragged down by aggressive fiscal consolidation and persistently high financial stress, after tensions eased temporarily in the first quarter.

Therefore, emerging economies will recover their growth differential vis-à-vis developed economies, of around 4 percentage points, for the whole of 2012 and 2013. In turn, growth gaps between Europe and the US also will continue to increase even as financial tensions slowly lower in the former from expected decisive policy actions.

All in all, our growth projections are not very different from those of our previous Global Economic Outlook (published in February). We expect global growth of 3.6% in 2012 and 4% in 2013, with emerging economies contributing around 80% of the increase in global activity (Chart 1). But this scenario is conditioned on a benign evolution of the crisis in Europe, and thus risks to our projections are still strongly tilted to the downside.

Monetary policies in advanced economies will continue to be very accommodative for an extended period. However, the effectiveness of further policy intervention (conventional or not) is decreasing, while at the same time the costs are increasing, including the risk of reduced central bank independence and the collateral damage from unconventional measures.. Policymakers in the US and Europe will need to take up part of the burden of reviving growth by implementing economic and institutional reforms and managing fiscal risks. While these measures take effect, central banks should continue providing support for an adequate functioning of the monetary transmission mechanism.

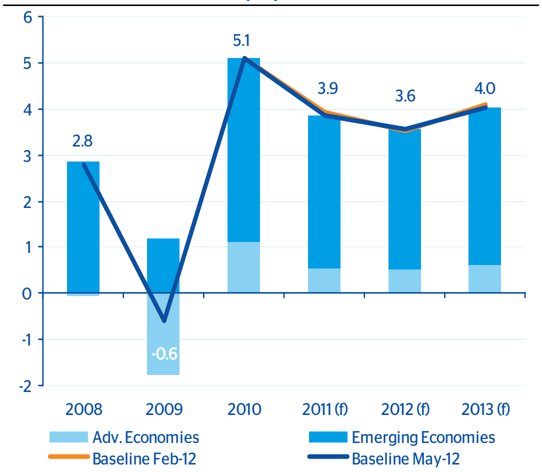
Easy monetary policies in advanced economies will mean favourable financing conditions in emerging countries. Here central banks will have to weigh the pressure from capital inflows and uncertain external demand against inflationary risks (in part from oil prices) and strong domestic demand. The difference in inflation projections in Asia and Latin America – declining in the former but stable in the latter- will condition a different outlook for monetary policies. We expect limited further easing in emerging Asia, and a cautious tightening bias in most of Latin America, except in Brazil.

There have been advances towards a solution to the European crisis, but crucial steps still need to be taken

Europe needs a clear roadmap to end the crisis. Despite some advances in recent months, there remain many important pending issues. First, while Greek sovereign debt held by the private sector was restructured, substantial doubts about long-run sustainability persist, due to reform fatigue and a possible deeper recession than projected. Second, the European Stabilization mechanism (ESM) has been provided with a fresh lending capacity of 500bn EUR (on top of

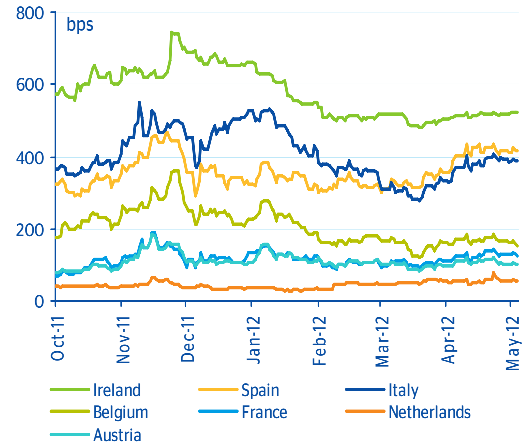
200bn already committed by the EFSF). However, that has not been enough to quell market anxiety, given Spain and Italy's financing needs for the next 3 years and the presumption that ESM loans would be senior to existing private bondholders. Further, it was not clear to what extent the increase in IMF resources of 430bn USD could be targeted to European countries. And third, there remain questions about the strength of the fiscal compact that sanctioned (pending national approval), committing governments to structural deficits not bigger than 0.5% of GDP. Although it is a significant change towards controlling member's budgets, the allowance for deviations to the rule under "exceptional circumstances" may undermine its perceived strengths among hardliners at the ECB. In addition, there have been no advances towards a fiscal union or Eurobonds.

Chart 1
Global GDP Growth (%qoq)



Source: BBVA Research

Chart 2
European sovereign risk premia (10yr bond spreads to Germany, bps)



Source: Datastream and BBVA Research

A new flare-up of the European crisis is still the main global risk

Undoubtedly, one of the most important actions in the last four months was the provision of long-term liquidity by the ECB. This allowed, at least until March, a significant reduction in liquidity risk in European banks, a timid opening of wholesale funding markets and a compression of sovereign spreads in peripheral countries. But these positive effects proved temporary as risk premia have increased rapidly since March in Italy and Spain (Chart 2).

The short-lived effect of the long-term liquidity injections and the conundrum between fiscal consolidation and restoring growth highlight two conclusions. First, ECB actions can only bridge the short-run while the underlying economic and institutional problems are tackled. Economic reforms should be pushed forward, while core countries stimulate demand in the Eurozone. Second, it is imperative to reconsider near-term fiscal consolidation paths in a more gradual trajectory in exchange for comprehensive, detailed medium-term consolidation plans.

Current oil prices will have only a moderate impact on global growth, although a price spike poses a significant risk

A second threat to the global economy is a further increase in oil prices. The recent spike at the beginning of 2012 can be traced in part to tightening supply and demand fundamentals and also to an increase in the geopolitical risk premium to around 10-15 USD per barrel, due to tensions about Iran and limited market buffers (oil inventories and producer's spare capacity).

In our baseline scenario, we consider prices around 120 USD per barrel of Brent oil for much of 2012, around 15% higher than in our February forecasts. In our view, this will only have a moderate negative impact on global growth, as central banks in advanced countries view this as a temporary shock and will maintain accommodative policies. Nevertheless, should the conflict in the Gulf escalate, there could be a very large spike in oil prices, and even if central banks do not react, growth could be damaged through the associated increase in global risk aversion.

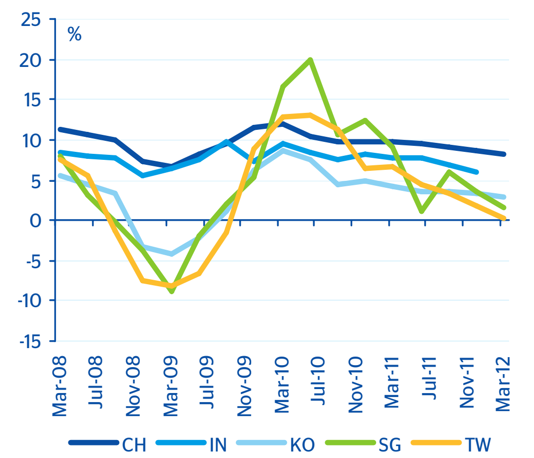
2. Has growth bottomed out?

Policymakers in Asia shifted gears from preventing overheating in early 2011 to supporting growth and guarding against downside risks to the global economy later in the year. Thus far, they appear to have been successful in guiding their economies to a soft landing, although concerns persist about the outlook given downside risks to the global economy, as noted above in Section 1.

Under our baseline of an improving external outlook, and consistent with our previous Asia Outlooks, we believe the region is now poised for a gradual upturn, although caution is in order given renewed external headwinds. The impact of recent policy easing, a rebound from last year's natural disasters in Japan and Thailand and, going forward, a strengthening of external demand should set the stage for a pickup in growth during the remainder of the year. While first quarter growth continued to moderate on a year-over-year basis, some economies have already seen a pickup in sequential terms (such as Korea, Singapore, and Taiwan). In other cases, forward-looking indicators are tentatively pointing to a rebound in coming quarters, most significantly in China. Downside risks continue to loom large, however, and higher oil prices have created new headwinds, resulting in a slight lowering of our full-year GDP projections for 2012, as explained below in Section 3.

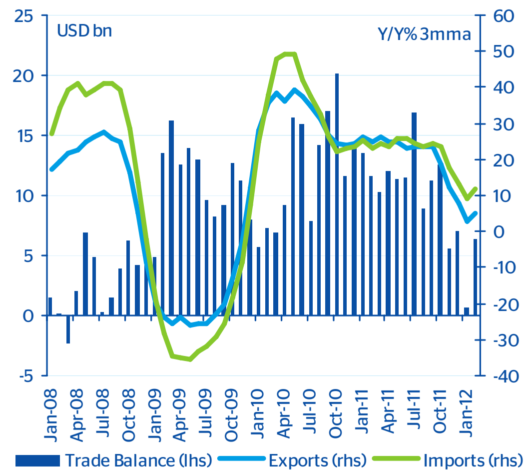
Policies remain appropriately growth supportive across the region. With rising oil prices adding to inflation pressures, some central banks have put further monetary policy easing on hold (such as Singapore, which recently tightened policy). Others in the region are continuing to ease, such as Australia, Japan (through QE), China and India. Where there is room, fiscal policies generally remain growth supportive as well.

Chart 3
Asia's growth continues to moderate...



Source: CEIC and BBVA Research

Chart 4
...on lower export growth and shrinking trade surpluses



Source: CEIC and BBVA Research
*Data includes AU, HK, ID, KO, MY, SG, TW and TH

Slowing growth, in line with expectations

As expected, full-year growth outturns across Asia slowed in 2011 (Chart 3) due to the effects of earlier policy tightening and weakness in the global economy. On the demand side, investment growth waned as the year progressed due to uncertainties about the external environment. An exception was Indonesia, where growth actually picked up on strong domestic demand and commodity exports, reaching 6.5% y/y (from 6.1% y/y in 2010), the highest level since the Asian Financial Crisis. In China, meanwhile, growth slowed to a more sustainable pace of 9.2% y/y (from 10.4% in 2010) as the authorities' sought to achieve a soft landing, while growth in India slowed to 7.1% y/y (from 8.5%) as business confidence weakened due to high inflation, rising interest rates and policy slippages on the reform front. Growth in Japan contracted by -0.7% y/y due to the impact of the March earthquake and tsunami along with supply disruptions from the floods in

Thailand later in the year. For the remainder of Asia, growth outturns were broadly in line with our expectations, and reflect the region's resilience despite the challenging global environment.

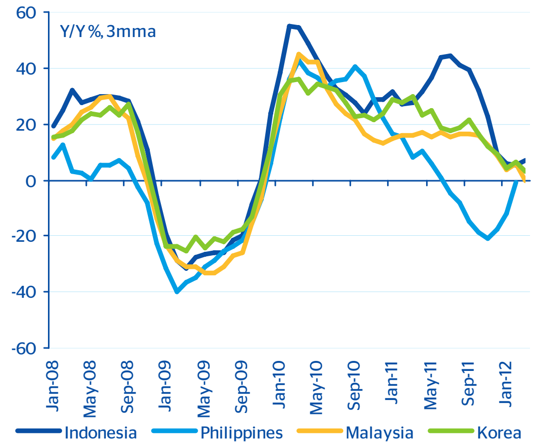
Growth outturns in 2012 have thus far also been broadly in line with expectations. China was an exception, with first quarter growth (8.1% y/y) coming in below our expectations (8.7%) on weaker than expected investment. In other cases, such as Singapore (1.0% y/y) and Korea (2.8% y/y), first quarter growth exceeded our expectations by small margins.

Financial spillovers from the turbulence in Europe have thus far been limited, with regional banks (particularly in Japan) partially offsetting the retrenchment by European lenders. The most recent BIS data from the fourth quarter of 2011 shows that European lending to Asia ex-Japan contracted by 4.9% q/q, the second straight quarterly decline. However, lending from Japan and Australia actually increased over the same period. A further sign that Asia is weathering the storm comes from anecdotal evidence that Asian trade finance has yet to be significantly affected by the European crisis.

Weak external demand: the main contributor to the moderation in activity

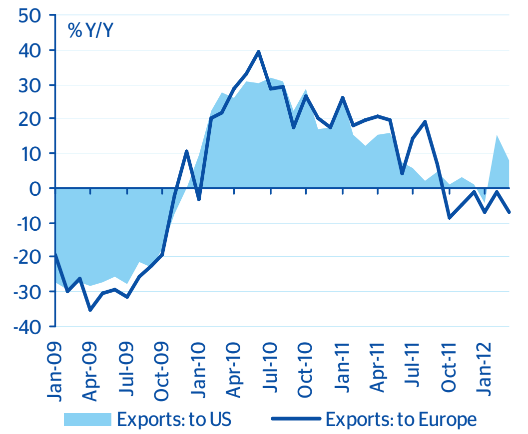
Overall, however, external demand remains weak, and is the key factor slowing growth. Trade balances narrowed in early 2012 (Chart 4) on lower exports (Chart 5) as weaker demand from Europe (-7.8% y/y in March, the sixth straight monthly decline) has been only partially offset by stronger exports to the US (+7.1% y/y in March, Chart 6). Intraregional trade, which had previously provided a partial offset to the external slowdown, has waned recently, primarily due to a slowdown in Chinese demand (Chart 7). However, it is worth pointing out that export growth to China has declined due to weak external demand (i.e. goods China produces and ships to other countries), while exports for Chinese final demand have improved, helping to support overall export levels.

Chart 5
Overall, exports have continued to weaken...



Source: CEIC and BBVA Research

Chart 6
...though exports to the US rebounded in 1Q12

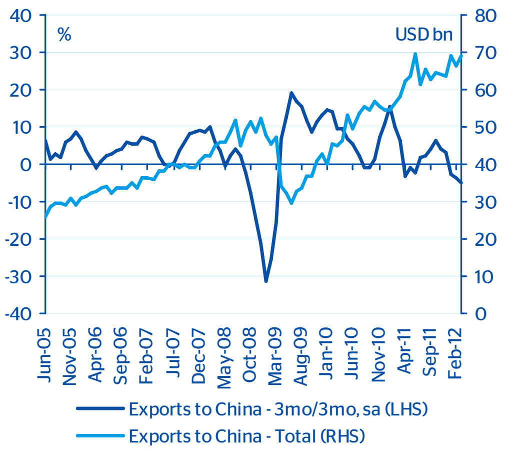


Source: CEIC and BBVA Research
*Data includes AU, HK, ID, KO, MY, SG, TW and TH

Industrial production continues to decelerate in a number of economies (Chart 8). In India, for example, the manufacturing sector has been under pressure due to domestic headwinds from high interest rates (in response to weakening growth, the Reserve Bank of India recently lowered interest rates by 50bps, to 8.0%). Industrial production has also slowed further in Korea (0.3% y/y in March), on weakness in auto production.

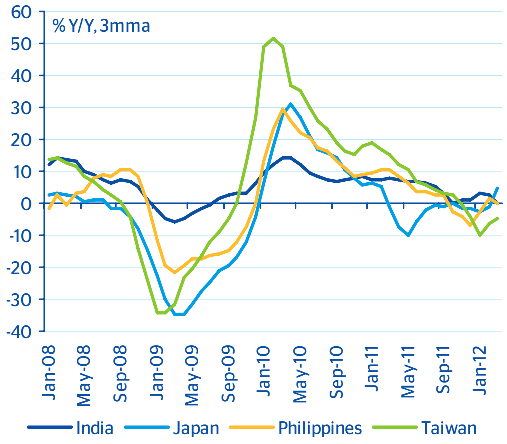
In Japan, on the other hand, recent activity indicators are picking up. Industrial production, especially in the auto sector, has rebounded following a normalization of supply chains from the disruptions of the March 2011 earthquake and floods in Thailand later in the year. Exports have also been recovering, and consumer spending has increased on improved sentiment. Looking ahead, post-quake reconstruction spending should continue to provide a boost to the economy in the coming months.

Chart 7
Slowing demand from China is affecting the region



Source: CEIC and BBVA Research
* Data includes AU, JP, HK, IN, ID, KO, MY, PH, SG, TW, TH, and VN

Chart 8
Industrial production also continues to moderate



Source: CEIC and BBVA Research

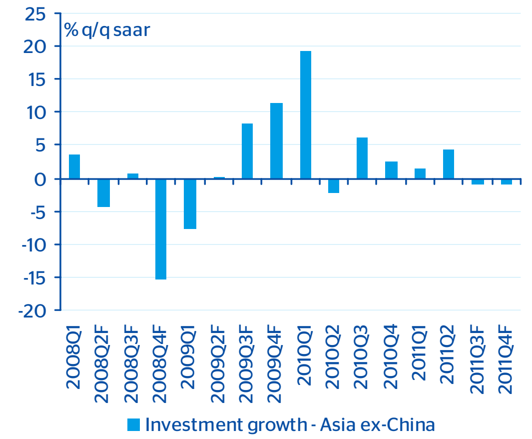
Developments in India have been challenging due to the presence of "twin deficits" (current account and fiscal), a sluggish pace of policy reform, and the impact of previous policy tightening to contain high inflation. Such headwinds were cited as key factors in S&P's April decision to lower India's sovereign outlook to negative (an actual ratings downgrade, should it occur, would bring India's rating to below investment grade). While the new budget for FY13 announced in March provided a credible path for much needed fiscal consolidation, it disappointed markets by failing to clarify taxation policies (especially over proposed tax avoidance regulation knows as GAAR) and by falling short in reforms to stimulate growth, particularly in infrastructure, and opening the banking and retail sectors.

Spillovers from the external environment to domestic demand and credit

Robust domestic demand has offset weakening exports throughout the region over the past several quarters. That said, signs of some softening in domestic demand have emerged, particularly in investment (Chart 9) given the uncertain outlook. Indicators of consumption have been mixed, with retail sales weakening in a number of economies including Hong Kong, Singapore, Taiwan, and India (Chart 10). On the other hand, retail sales have continued to perform well in Australia, Malaysia, Korea and, as noted above, in Japan. Consumer sentiment generally remains strong (Chart 11), although it has weakened in Indonesia on account of expectations of rising domestic fuel prices.

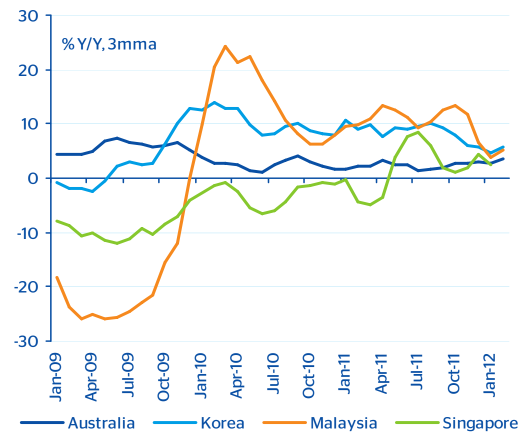
Credit growth, a factor which helped sustain domestic demand until recently, has begun to slow across much of the region (Chart 12). The slowdown probably reflects a mix of factors, including weaker credit demand and more risk averse behavior by banks due to the financial tensions in Europe. Nevertheless, credit growth remains quite high in countries like Singapore (27.6% y/y) and Indonesia (24.2% y/y). More broadly, the transmission of European bank deleveraging to domestic credit conditions has been limited as Asian banks are well-capitalized and well-positioned to pick up the slack from foreign banks.

Chart 9
The investment environment has been difficult



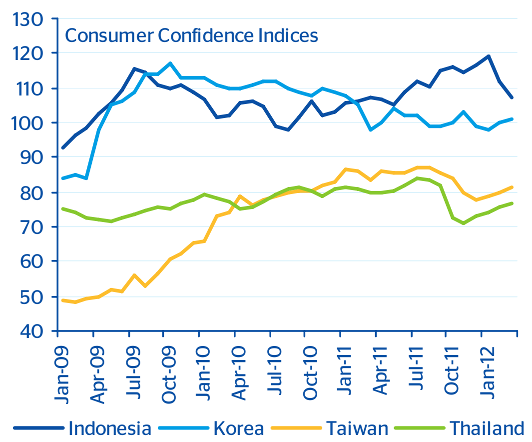
Source: CEIC and BBVA Research

Chart 10
Retail sales have been mixed



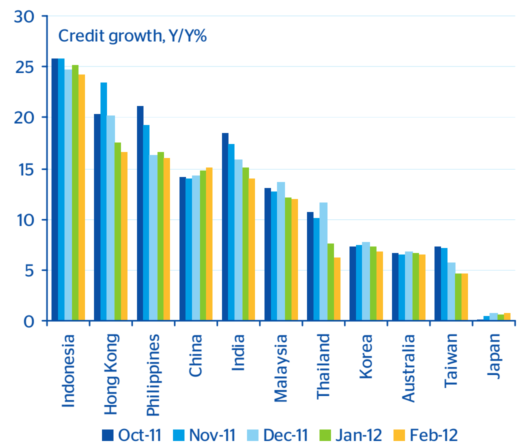
Source: CEIC and BBVA Research

Chart 11
Consumer confidence has been rising



Source: CEIC and BBVA Research

Chart 12
Credit has slowed as banks have turned cautious



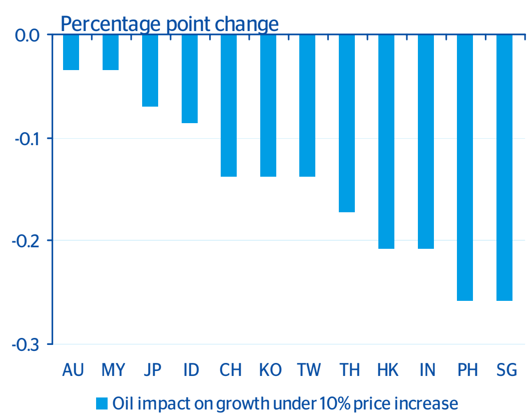
Source: CEIC and BBVA Research

Forward-looking indicators show growth may be bottoming out

While we remain cautious given external headwinds and the potential impact higher oil prices could have on growth (Chart 13), a number of PMI outturns, most notably in China, have improved (Chart 14), offering some tentative signs that growth may be bottoming out. Korea's PMI moved into expansionary territory in February for the first time since mid-2011, and reached one-year high of 52.0 in March.

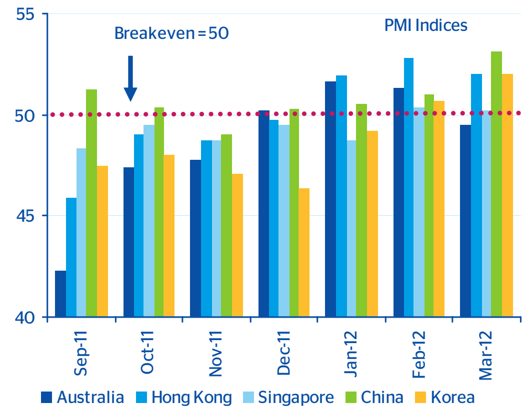
Inventory-shipment ratios, another important forward-looking indicator, have improved in Korea and Taiwan (Chart 15), though they remain high. Inventories appear to be stabilizing alongside an increase in the region's electronics shipments to the developed world (Chart 16). Other tentative signs of stabilization include Taiwan export orders and China's imports of processing goods (a leading indicator of export demand), which have improved after a very weak start to the year in January (Chart 17), as well as rising business confidence indices, particularly in Thailand and the Philippines.

Chart 13
A further rise in oil prices could adversely affect Asian growth



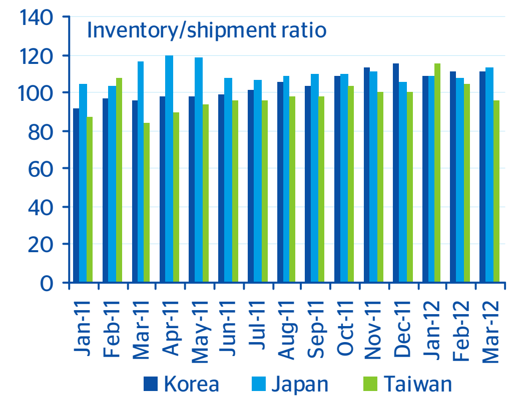
Source: CEIC and BBVA Research

Chart 14
Manufacturing PMI shows an improving outlook…



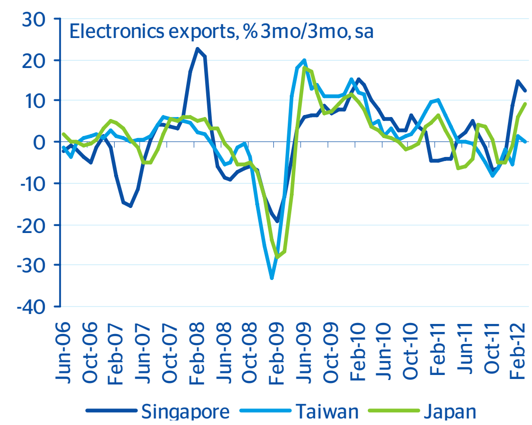
Source: CEIC and BBVA Research

Chart 15
…and while I/S ratios are still high…



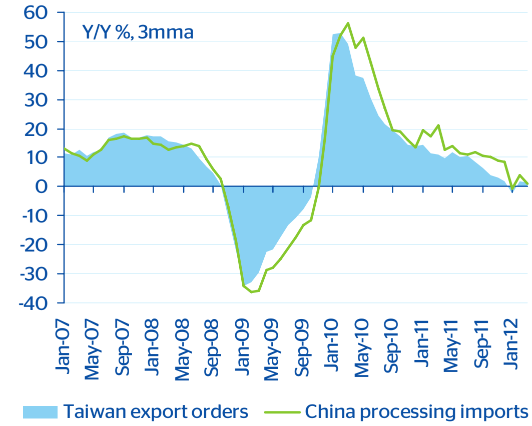
Source: CEIC and BBVA Research

Chart 16
…there has been an increase in higher-end exports like electronics products



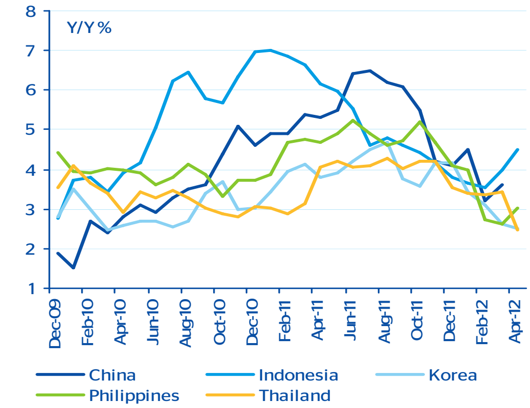
Source: CEIC and BBVA Research

Chart 17
Forward-looking export indicators have stopped declining (for now)



Source: CEIC and BBVA Research

Chart 18
Headline inflation rates have generally fallen



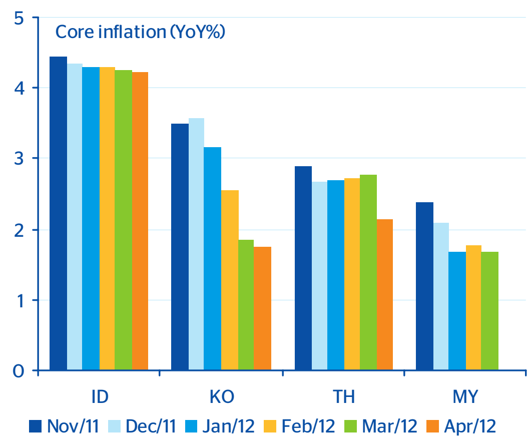
Source: CEIC and BBVA Research

Welcome declines in inflation despite higher oil prices

With demand pressures easing due to slowing growth, inflation has fallen within policymakers' comfort ranges. China and Korea (3.6% y/y and 2.5% respectively), have experienced welcome declines in headline and core inflation (Charts 18 and 19). There are, however, still cases where inflation remains elevated, such as in India (6.9% y/y), Hong Kong (4.9% y/y), and Singapore (5.2% y/y) although they too have seen welcome declines this year. In India, however, food inflation (accounting for 23% of the inflation basket) remains a concern (Chart 23), exacerbated by imported inflation due to weakness in the rupee.

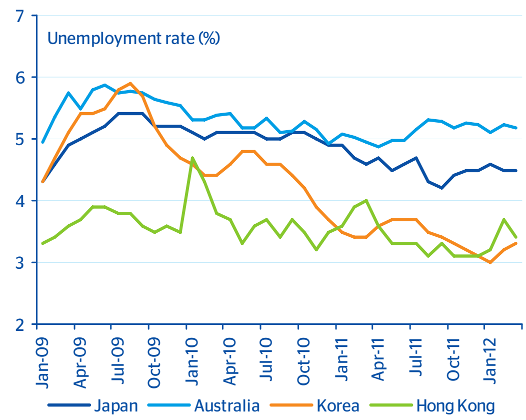
Despite the general downtrend, price pressures continue to lurk beneath the surface, which is likely to keep monetary authorities' vigilant. In particular, unemployment rates remain low by historical standards (Chart 20), which has led to persistent wage increases (Chart 21). Rising oil prices remain a threat – our analysis suggests that for every 10% increase in oil prices, inflation rates rise by around 0.1-0.5% in most Asian economies (Chart 22).

Chart 19
Core inflation has declined due to weakening demand-side pressures...



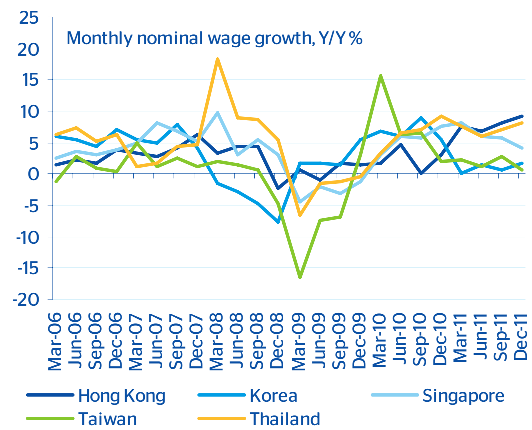
Source: CEIC and BBVA Research

Chart 20
...but tight labor markets...



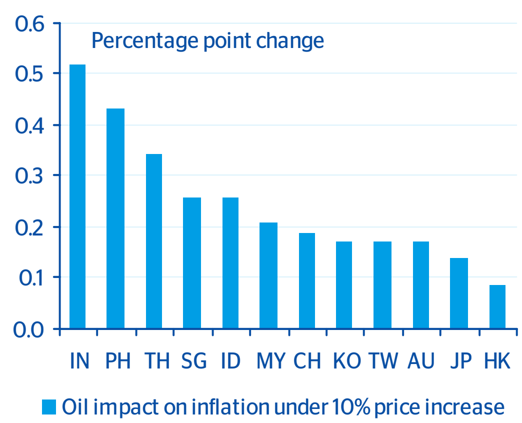
Source: CEIC and BBVA Research

Chart 21
...and persistent wage increases will keep inflation from falling much further...



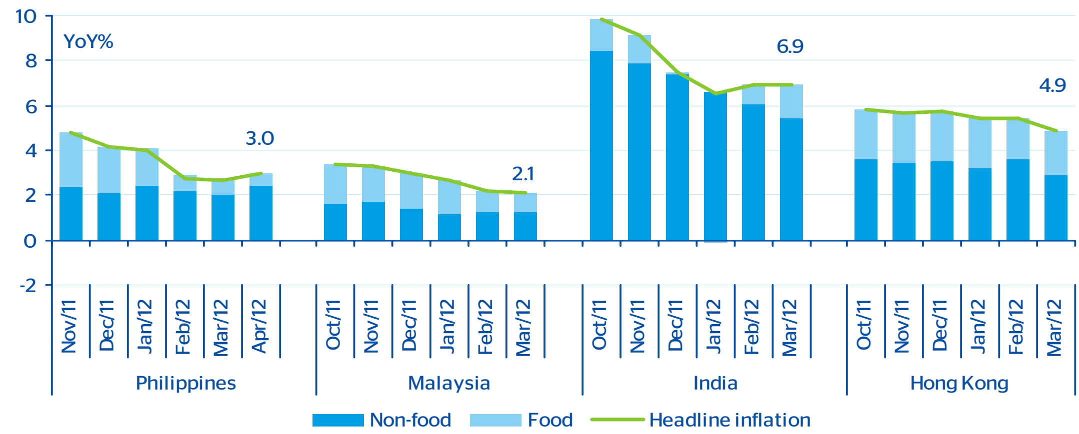
Source: CEIC and BBVA Research

Chart 22
...while rising oil prices may also drive inflation higher



Source: CEIC and BBVA Research

Chart 23
Easing food prices and base effects have been driving inflation lower



Source: CEIC and BBVA Research

Further room for monetary policy easing to support growth

Monetary policy stances remain growth supportive. Four countries – the Philippines (50bps), India (50bps), Australia (50bps) and Indonesia (25bps) have cut their policy rates this year in order to help support growth (Chart 24). The Philippines' decision to cut rates was part of a coordinated effort by the government to front-load both fiscal and monetary policies in the first half of 2012 after it posted lower-than-expected growth of 3.7% in 2012 (the government's target was 4.5%-5.5%). Indonesia has now cut rates by a total of 100bps since October, but given the country's strong growth and possibility of a fuel price hike in the coming months, these cuts may, in hindsight, have been overly aggressive. Inflation is expected to rise in the second half of the year, which may cause authorities to reverse policy by tightening. Meanwhile, Australia surprised markets with a larger-than-expected 50bp cut on May 1 following a lower-than-expected Q1 inflation outturn, in an effort to encourage banks to lower their lending rates to support growth; the magnitude of India's April 17 50bp cut was also a surprise to markets.

China has continued to ease monetary policy through cuts in the required reserve ratio, while Japan has stepped up its quantitative easing. Regarding the latter, under growing political pressure to end deflation, the Bank of Japan announced an informal inflation target of 1% in February, along with increases in its asset purchase program. The BoJ's movements have caused a noticeable increase in the volatility of the yen. With inflation outlook to remain below 1% in the year, the BoJ is expected to boost stimulus again in the following months.

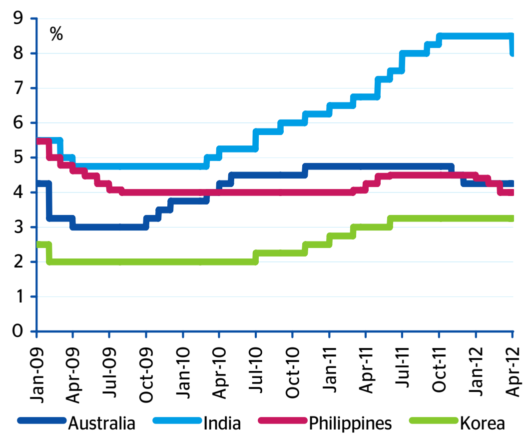
Some central banks have signaled they will refrain from further aggressive interest rate cuts, not only to guard against inflation risks, but to save room in the event of a further deterioration in the global economy. Thailand, Malaysia, and Korea have all been on hold, with the former hoping to keep a lid on inflation despite the severity of the flooding in October. Policymakers in these countries have emphasized the potential impact of rising oil prices on inflation, which could reverse recent positive shifts in real interest rates (Chart 25). Meanwhile, Singapore surprised observers by tightening monetary policy at its semi-annual meeting in April, increasing the pace of currency appreciation to combat stubbornly high inflation. The decision appeared justified after March's inflation reading (5.2% y/y) showed accelerating price pressures (February: 4.6% y/y), and after the authorities raised their inflation outlook for 2012 to 3.5%-4.5% from 2.5%-3.5%.

Fiscal policies are increasingly coming into focus

Fiscal expansion will have a significant impact on regional growth in 2012. Overall, there is a mildly expansionary bias in 2012 fiscal policy settings (Chart 26). Country authorities are tending to focus on affordable housing construction, infrastructure development, and small businesses. However, in some cases there have been policy slippages, such as in Indonesia, where a planned fuel price increase on April 1 was postponed. While the postponement does not put the deficit at risk, it does raise questions about the composition of spending (on poorly targeted subsidies) and was cited by S&P as a factor for its recent decision not to upgrade the country to investment grade (S&P thus remains a notch below Moody's and Fitch on Indonesia). Nevertheless, Indonesia continues to attract strong FDI inflows, and it also placed a highly successful US dollar bond issue in the middle of April.

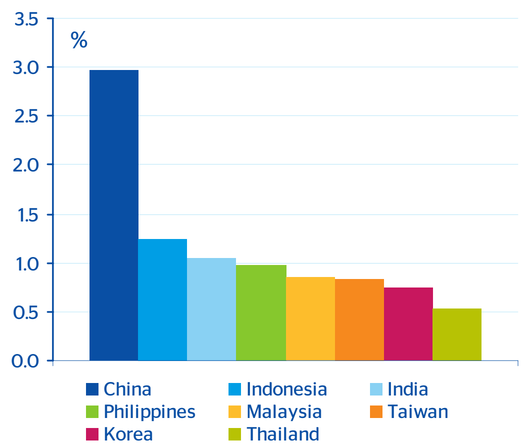
An ongoing concern in Japan is the high level of public debt, which now stands at around 220% of GDP through the first quarter, and has been increasing due to extra budget spending for the post-quake reconstruction. The Japanese government has proposed to increase the consumption tax from 5% to 10% by 2015, although political resistance makes legislative passage uncertain.

Chart 24
Monetary policies are accommodative...



Source: CEIC and BBVA Research

Chart 25
...as real interest rates have become more positive



Source: CEIC and BBVA Research

Chart 26
Fiscal policies remain supportive

2012 Fiscal Budgets			
Country	**Expansionary, Contractionary, Neutral?**	**Official Deficit Target**	**Key Features**
China	Expansionary	1.5% of GDP	Increased spending on social housing; replacing business tax with VAT in selected service sectors; new consumption subsidies; structural tax cuts i.e. on energy-efficient vehicles
Hong Kong	Expansionary	0.2% of GDP	Ongoing support for SMEs through favorable tax credits; increasing the land supply and launching subsidized housing programs; income tax reductions; subsidize electricity tariffs
Indonesia	Expansionary	2.2% of GDP	Increasing civil servant salaries; raising subsidized fuel prices; reduced customs duties on coal
Malaysia	Expansionary	4.7% of GDP	Financial support for purchases of new homes
Philippines	Expansionary	2.6% of GDP	Infrastructure spending; agricultural and industrial support services; public-private partnerships

Source: CEIC, central bank websites and BBVA Research

Asian currency and equity markets: volatility due to external uncertainty

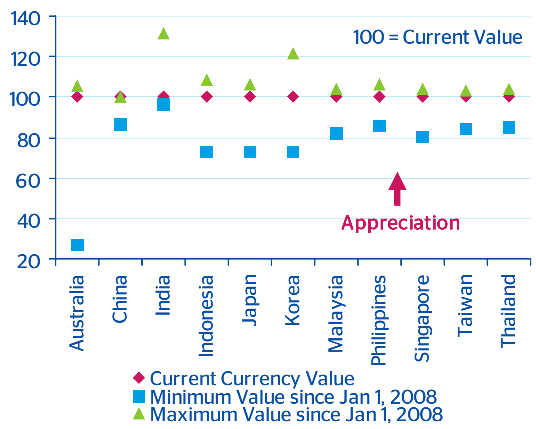
As with markets in the rest of the world, Asian currencies and equities have risen and fallen in line with global risk sentiment. A number of currencies in the region have appreciated in 2012, including the Singapore dollar (+4.8% against the USD) following the MAS policy tightening in April. Other countries whose currencies have appreciated thus far in 2012 include Taiwan, the Philippines, Korea, and Malaysia.

A few notable exceptions to the appreciation trend are India, Australia, and Japan. The former has continued to see rupee weakness to near record lows on pessimism arising from India's twin deficits and sluggish policy reforms. The Australia dollar has come off its highs on signs of slowing growth and easing commodity demand from China, as well as recent RBA interest rate cuts. The yen has been volatile: after depreciating to around 84 per USD from early February to mid-March due to earlier intervention, a rise in risk appetite that resulted in some outflows, as well as a widening trade deficit, the currency has more recently appreciated back towards the 80 level against the USD.

While a quarterly perspective may help convey shorter-term trends, by extending our analysis of Asian currencies over a longer time horizon (Chart 27), back to 2008 (prior to the global financial crisis), we can understand more broadly which currencies are increasingly being favored by investors. Under this analysis, the Australia dollar emerges as the best performing Asian currency, increasing 71% from its trough. Next are the Korean Won (27.6%), the Indonesian rupiah (27.4%), and the yen (27.2%). The chart below shows that many Asian currencies are currently near their historic highs, and most have rallied strongly from their lows.

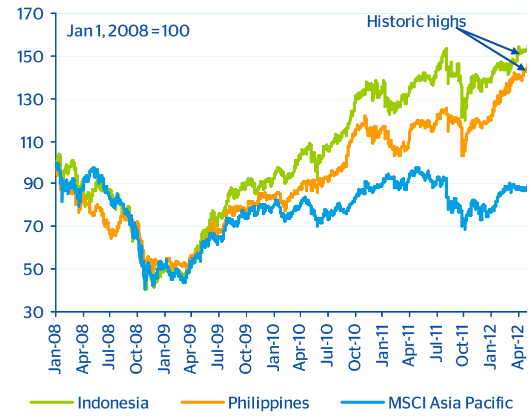
Turning to the region's equity markets, the Philippines has been the clear outperformer in the region over the past quarter (Chart 28), having gained 19.6% since the beginning of the year and reaching a historical high in early May. Investors have been attracted by the performance of the current government and a possible ratings upgrade to investment grade. Indonesia's stock market has been on a similar trajectory, reaching a new historic high in early April. Japan's Nikkei also stands out (+12.2% in 2012).

Chart 27
FX: Asia has rebounded strongly after the financial crisis*



Source: Bloomberg and BBVA Research
* as of May 8, 2012

Chart 28
Equity markets in the Philippines and Indonesia have reached historic highs



Source: Bloomberg and BBVA Research

3. Small downward growth revisions on headwinds from oil prices

While recent growth outturns have been largely in line with expectations, we have made small downward revisions to our 2012 growth projections to reflect the impact of a higher oil price assumption under our baseline. Taken alone, the higher oil price path would have normally resulted in slightly larger downward revisions. However, in view of supportive policies and signs that growth may have already bottomed out, our downward revisions are quite modest (Table 1). Our projections for 2013 remain unchanged. These projections, however, continue to be subject to downside risks due to uncertainties in the global environment, particularly from Europe.

Small downward revisions to 2012 growth forecasts

Growth is expected to improve gradually over the remainder of 2012. Growth in the Asia-Pacific region is now forecast to be 5.7% y/y in 2012, down from 5.8% y/y in our previous forecasts. On an individual basis, our most significant downward revision is for Japan (to 1.9% y/y, from 2.2% previously), given weaker-than-expected growth momentum in the fourth quarter of last year, its struggles with fiscal consolidation, as well as the expected impact of higher oil prices on industrial output. We have also revised our projection for India downwards to 6.8% y/y (from 7.0% y/y), as the economy continues to struggle with regulatory bottlenecks as well as twin deficits. We have revised our projection for Hong Kong downwards by 0.2%, to 2.9% y/y on account of higher oil prices. The remainder of our individual country revisions are no more than -0.1% y/y, and notably we are keeping our China growth projection unchanged at 8.3% y/y.

Inflationary pressures likely to increase

The benign inflationary trend in recent months is expected to gradually end in countries like Indonesia (where we forecast full year average inflation of 5.4% y/y in 2012), and India (6.9% y/y in 2012) due to base effects, lags from policy cuts in the second half of last year, and the aforementioned increase in oil prices. Tight domestic labor market conditions will also likely keep food and transport prices from falling significantly, creating a floor under inflation. Moreover, under our baseline of gradually improving risk appetite in 2012, capital inflows to Asian economies are likely to resume, which could put further upward pressure on asset prices. As a result, we have made upward adjustments to our inflation forecasts across the region (Table 2) – in addition to India and Indonesia, we have revised Taiwan up by 0.4% y/y (to 1.5% y/y) and made relatively minor adjustments to China (3.5% y/y from 3.3% y/y previously), Korea (3.4% y/y from 3.2% y/y), and Singapore (3.3% y/y from 3.0% y/y).

Indonesia's inflation forecast remains dependent on the timing of a possible fuel price increase to reduce subsidies. Such an increase would cause inflation to rise sharply.

Policymakers have room to cut rates, but some will exercise caution

While some monetary authorities will opt to keep interest rates on hold, we expect further easing in China, India, Australia, and Japan. In China this will take the form of further cuts in the RRR, accompanied by possible 25-50bps cuts in interest rates, especially if the external environment fails to improve. We expect another 50bps of interest rate cuts in India and 25bps in Australia in the coming 1-2 quarters.

At the same time, we have taken out some of the rate cuts we had previously expected in other countries (Table 4), as we expect policymakers to preserve space in case global conditions worsen. In Korea, where household debt remains high, under our current baseline we expect policy to remain on hold, although the chance of a rate cut is increasing in view of weakening exports and a larger-than-expected fall in inflation for April (to 2.5% y/y). In Thailand and Malaysia, the authorities have focused on reigning in inflation, and we now expect policy to remain on hold in both countries. Malaysia posted better-than-expected growth in 2011, while Thailand is expected to post solid growth in 2012 during its recovery from last year's flooding. In Taiwan, growing inflationary pressure and a better-than-expected start to 2012 should also allow policymakers to keep interest rates on hold.

We expect Indonesia to begin raising interest rates by the end of the year (from their current 5.75%), due to an increased likelihood that inflation will pick up towards the end of 2012, especially if the previously postponed fuel price hike eventually goes through.

Currencies may weaken in the near-term before rebounding in 2H12

Asian currencies strengthened at the start of 2012 and since have tapered off somewhat. We expect most of Asia FX to depreciate prior to the second half of the year, before a gradual appreciation begins in tandem with the emerging global rebound. The outlier is the Japanese yen, which we expect will depreciate through the year (Table 3). Some currencies, like the rupee, will be closely watched given their recent weakness, with risks still remaining to the downside given expected further policy rate cuts. As for the RMB, which is the currency that generally attracts the most attention in Asia, we expect further appreciation of around 3% this year, despite forward rates pricing in no further appreciation, as we think a planned shift to a consumption-based economy argues for a stronger currency.

4. Downside risks to the outlook

As has been a persistent theme for the past several quarters, downside risks dominate the outlook due to uncertainties about the global environment, especially in Europe. Even if downside risks do not materialize and our external baseline remains intact, there is the possibility that the rebound we expect in Asia during the remainder of the year may not materialize. Domestic demand may fail to be as robust as we expect, and the impact of higher oil prices could dent growth more than we project at present.

The most significant risk to the outlook is the uncertain global environment. While the region has so far been resilient to the financial tensions and economic downturn in Europe, should a more severe crisis take hold, or if downside risks to momentum in China materialize, growth in Asian economies would slow by much more than expected in our baseline. The region's smaller and more export-oriented economies would remain most vulnerable due to a weakening in external demand.

There remains the risk that weakening exports could spill over to domestic demand by more than has been the case at present. Evidence of this is already available in a number of economies, such as Korea, and slowing credit growth in the region could portend some additional weakening of domestic demand. The region's larger economies should be more resilient, although slowing growth in India is an ongoing concern that will need to be watched in the months ahead.

Another important risk is rising oil prices, especially in the event of supply disruptions from tensions in the Middle East. A spike beyond our current baseline would result in somewhat lower growth in Asia's energy dependent economies, especially in Singapore, Hong Kong, India and, to a lesser extent, in Korea and Taiwan. Inflation rates would also be correspondingly higher, and would limit the room for monetary easing to counter a shock.

Geopolitical risks continue to bear watching across Asia. Should there be a flare-up, territorial disputes in the South China Sea, and ongoing tensions between North and South Korea could undermine sentiment.

Country specific uncertainties relate to Presidential elections in Korea later this year, lingering risks of a steeper slowdown in China, and macro instability and slowing growth in India. In China, the run-up to the political transition later this year and early 2013 has been more turbulent than expected, although we continue to expect leadership change to be smooth.

5. Tables

Table 1

Macroeconomic Forecasts: Gross Domestic Product

(YoY% growth rate)	2009	2010	2011	2012 (F)	2013 (F)
U.S.	-3.5	3.0	1.7	2.3	2.2
EMU	-4.2	1.8	1.6	-0.2	0.9
Asia-Pacific	4.2	8.1	5.7	5.7	6.1
Australia	1.5	2.4	1.8	3.1	3.4
Japan	-5.5	4.4	-0.4	1.9	1.4
China	9.2	10.4	9.2	8.3	8.7
Hong Kong	-2.7	7.0	5.0	2.9	4.3
India	9.1	8.8	7.1	6.8	7.4
Indonesia	4.6	6.1	6.5	6.1	6.4
Korea	0.3	6.2	3.6	2.9	4.0
Malaysia	-1.6	7.2	5.1	4.2	5.1
Philippines	1.1	7.6	3.7	3.7	4.7
Singapore	-0.8	14.5	4.9	2.6	4.7
Taiwan	-1.9	10.8	4.0	3.2	4.5
Thailand	-2.3	7.8	0.1	4.5	5.2
Vietnam	5.3	6.8	5.9	5.9	7.2
Asia ex China	1.0	6.7	3.4	4.1	4.4
World	-0.6	5.1	3.9	3.6	4.0

Source: CEIC and BBVA Research

Table 2

Macroeconomic Forecasts: Inflation (Avg.)

(YoY% growth rate)	2009	2010	2011	2012 (F)	2013 (F)
U.S.	-0.3	1.6	3.2	2.5	2.3
EMU	0.3	1.6	2.7	2.4	1.5
Asia-Pacific	0.3	3.6	4.8	3.5	3.5
Australia	1.8	2.8	3.4	2.7	2.8
Japan	-1.4	-0.7	-0.3	-0.1	0.2
China	-0.8	3.3	5.4	3.5	3.8
Hong Kong	0.6	2.3	5.3	4.7	3.6
India	2.4	9.6	9.4	6.9	6.0
Indonesia	4.8	5.1	5.4	5.4	5.5
Korea	2.8	3.0	4.0	3.4	3.6
Malaysia	0.6	1.7	3.2	2.5	2.5
Philippines	3.2	3.8	4.4	3.9	4.2
Singapore	0.6	2.8	5.2	3.3	3.6
Taiwan	-0.9	1.0	1.4	1.5	1.5
Thailand	-0.8	3.3	3.8	3.7	3.0
Vietnam	6.9	10.0	18.1	12.3	8.8
Asia ex China	1.0	3.7	4.3	3.4	3.2
World	2.2	3.0	5.1	4.4	4.0

Source: CEIC and BBVA Research

Table 3

Macroeconomic Forecasts: Exchange Rates (End of period)

		2009	2010	2011	2012 (F)	2013 (F)
U.S.*	EUR/USD	0.72	0.76	0.72	0.78	0.77
EMU*	USD/EUR	1.39	1.33	1.39	1.28	1.30
Australia	USD/AUD	0.90	1.02	1.02	1.06	1.10
Japan	JPY/USD	92.1	81.1	76.9	84.0	88.0
China	CNY/USD	6.83	6.61	6.30	6.12	5.81
Hong Kong	HKD/USD	7.75	7.77	7.77	7.80	7.80
India	INR/USD	46.60	44.71	53.06	49.00	47.00
Indonesia	IDR/USD	9395	8996	9069	9050	9000
Korea	KRW/USD	1166	1126	1152	1100	1050
Malaysia	MYR/USD	3.52	3.06	3.17	3.05	2.90
Philippines	PHP/USD	46.8	43.8	43.80	43.00	43.00
Singapore	SGD/USD	1.40	1.28	1.30	1.23	1.19
Taiwan	NTD/USD	32.3	29.3	30.28	30.20	29.60
Thailand	THB/USD	33.3	30.1	31.55	30.50	30.50
Vietnam	VND/USD	17942	19498	21034	21500	22000

Source: CEIC and BBVA Research
* US and EU exchange rates represent period averages, all other exchange rates are end-of-period

Table 4

Macroeconomic Forecasts: Policy Rates (End of period)

(%)	Current	2010	2011	2012 (F)	2013 (F)
U.S.	0.25	0.25	0.25	0.25	0.25
EMU	1.00	1.00	1.00	1.00	1.00
Australia	3.75	4.75	4.25	3.50	4.50
Japan	0.10	0.10	0.10	0.10	0.25
China	6.56	5.81	6.56	6.06	6.56
Hong Kong	0.50	0.50	0.50	0.50	0.50
India	8.00	6.25	8.50	7.50	6.50
Indonesia	5.75	6.50	6.00	6.00	6.25
Korea	3.25	2.50	3.25	3.25	3.25
Malaysia	3.00	2.75	3.00	3.00	3.00
Philippines	4.00	4.00	4.50	4.00	4.00
Singapore	0.45	0.48	0.45	0.40	0.40
Taiwan	1.88	1.625	1.875	1.88	2.38
Thailand	3.00	2.00	3.25	3.25	3.50
Vietnam	9.00	9.00	9.00	9.00	9.00

Source: CEIC and BBVA Research

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