

Economic Outlook

Asia

Third Quarter 2012
Economic Analysis

- **The outlook for global growth is highly dependent on timely policy implementation in Europe and the US.** After a deterioration in economic conditions in the first half of 2012, our updated global scenario envisages a slight rebound in 2013.
- **We are revising our Asia growth projections downward due to weak first half outturns and the delayed global recovery.** In addition, slowing external demand is spilling over to domestic activity, exacerbating internally generated factors behind the loss of growth momentum, especially in India and China.
- **We project growth to pick up in the fourth quarter** on the effects of fiscal and monetary policy support, and an improving global environment. Falling inflation should provide room for further monetary easing in the coming months.
- **Risks to the outlook are heavily tilted to the downside.** In particular, if financial tensions intensify in Europe, negative effects in Asia would be transmitted through trade and financial channels, with policy support providing some cushion.

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Summary

Asian growth is slowing under pressure from the weak external environment. While growth has been relatively resilient, thanks to the region's strong fundamentals and domestic demand, second quarter outturns have come in below expectations due to external weakness and, in some cases, domestically generated factors. Moreover, with the European crisis having intensified, the likelihood of a pickup in growth is being pushed farther out, towards the fourth quarter of 2012. Risks to the outlook are to the downside owing to the uncertain external environment, from both weakness in Europe and the sluggish US recovery.

Second quarter indicators have been weaker than previously anticipated due to slowing export growth and weakening domestic demand. Among the region's larger economies, the slowdowns in India and China have been especially noticeable, with the former having much to do with uneven domestic policy implementation of structural reforms, and the latter owing in part to the effects of previous policy tightening. The region's more open economies, especially in North Asia, have also seen a pronounced slowdown. In contrast, growth in Southeast Asian economies, especially Indonesia, has continued to perform relatively well.

With inflation moderating, policymakers have stepped up the pace of monetary policy easing to counter external headwinds. While headline inflation remains high in a few countries, such as India and Singapore, price pressures have eased by more than expected due to softer demand pressures and easing commodity prices. As such, inflation is within or below official target ranges. Correspondingly, central banks in China, India, Korea, Australia and the Philippines have been more aggressive than previously expected cutting interest rates in recent months.

In view of the weaker outturns in the first half of the year and the delayed global recovery, we are revising downwards our 2012 and 2013 growth projections. For Asia Pacific, our new growth forecast is 5.4% y/y (from 5.7% y/y previously) in 2012 and 5.8% y/y (from 6.1% y/y) in 2013. The most significant downward revisions are for China (7.8%) and India (5.6%), due to weakening exports and sluggish investment. There are also a few upward revisions, namely for Japan, the Philippines, and Thailand due to stronger-than-expected first quarter outturns.

Risks are firmly to the downside, as financial tensions in Europe remain high. A further deterioration of the Euro crisis would have a significant growth impact on the Asian region, through both trade and financial channels. There are also risks of further slowdowns in India and China due to domestic factors. Even under our current baseline, negative spillovers to domestic demand, as is already apparent in a few countries, could exacerbate the region's growth slowdowns, with some cushion from further policy support.

To boost domestic demand and counter these risks, policy stimulus is likely to continue. We expect further monetary easing in China, India, Korea, and Australia. Prospects of easing in Taiwan and the Philippines are also increasing. While fiscal policies are generally supportive, there is room for additional measures in most countries if growth conditions worsen, although the room is limited in India and Japan due to large deficits and debt burdens. The likelihood of additional fiscal stimulus is highest in China, where steps are already being taken to accelerate infrastructure spending and social housing construction.

The outlook for currency markets is highly dependent on the evolution of the external environment. In the near term, Asian currency markets may be weighed down by global risk aversion, which could accelerate in the event of disappointment over the resolving of the European crisis. Owing to the weak external outlook and slowing growth in China, we have taken out expectations of appreciation of the RMB against the USD in 2012. That said, if European financial tensions ease, as anticipated toward the end of the year in our baseline, regional currencies should be well positioned for a rebound.

1. Summary: a slowdown that may deepen without decisive policy action

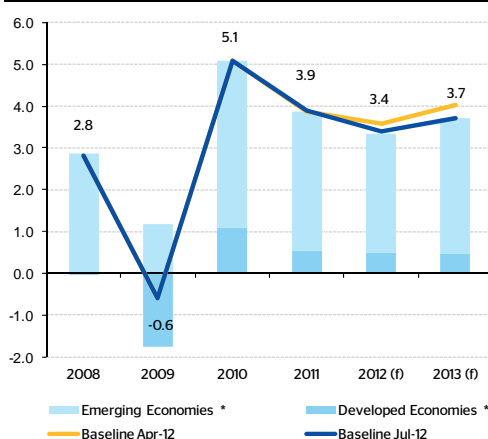
Before turning to Asia, we review the *Global Outlook*. Readers may go directly to the sections on Asia, if they wish, by turning to page 6.

Global growth will improve only with key policy implementation

After the deterioration in global economic conditions in the first part of 2012, our updated scenario envisaging a slight economic rebound in 2013 is dependent on economic policies. Our global GDP growth forecast stands at around 3.5% in 2012-13, on the assumption that several global policy measures are implemented. Some of them have already been announced or approved but await implementation; others have yet to be passed. Policy measures are needed to prevent a further financial deterioration in Europe, a steep US fiscal adjustment in 2013, and a slowdown in emerging economies.

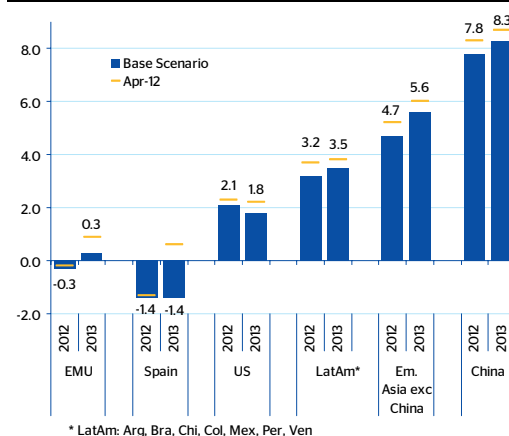
At their policy summit in June, eurozone leaders reached significant agreements to reinforce the currency union, including unified banking supervision in the euro area, far-reaching plans for banking and fiscal issues, and growth-supporting measures. However, financial-aid mechanisms to ensure financial stability (i.e., EFSF & ESM) still must be used to their full extents to prevent a financial "accident." In the US, an agreement is needed to prevent automatic spending-cuts and the expiration of tax cuts from taking effect at the beginning of 2013. Such a "fiscal cliff" would push the US economy back into recession. The presidential campaign makes an agreement difficult before the election.

Chart 1
Global GDP growth (%) to pick up in 2013



Source: BBVA Research

Chart 2
GDP growth (%) is being led by emerging markets



* LatAm: Arg, Bra, Chi, Col, Mex, Per, Ven

Source: BBVA Research

Meanwhile, in emerging economies with room for policy stimulus, measures are needed to prop up domestic demand to mitigate the effects of the external slowdown. Additionally, volatility of capital inflows could increase due to the ebbs and flows of the eurozone crisis and prospects of a new round of quantitative easing by the US Fed.

Failure to instill market confidence could drag out the euro crisis

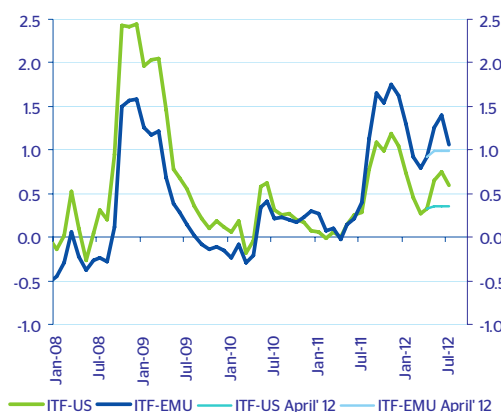
The main uncertainty over the current economic scenario is whether efforts to reinforce EU governance will be preceded by a further deterioration in the financial situation. The decisions already taken, if implemented forcefully and quickly, should suffice. These measures aim to eliminate emerging risks from the sovereign-banking feedback loop in Spain, and to stabilise financial markets across the eurozone with the active use of the EFSF/ESM in purchasing bonds in the primary and secondary markets. Recent policy measures in Spain to reign in the deficit and the strongly supportive stance by the President of the ECB are helping to ease tensions.

All in all we have revised downwards our previous forecasts of three months ago due to continued financial stress in the euro area and the deterioration in global economic confidence. Our new scenario implies a period of stagnation in the eurozone in 2012-13. The balance of risks continues to be tilted to the downside, given the likelihood that approved measures are introduced too slowly due to domestic-policy considerations in some countries.

The risk of a euro break-up, while still only a tail event in our view, is fueling the fragmentation of financial flows across the eurozone and impeding funding access for economies with a net debt position with the rest of the zone. Fast implementation of financial-aid mechanisms and reinforcement in size and access to the ECB's funding are key to eliminating the risk of a eurozone break up. In the end, the necessary measures will imply a transfer of national sovereignty to the European institutions with some form of liability sharing (debt mutualisation). If the challenges are met satisfactorily, global growth should gradually gain traction during 2H12.

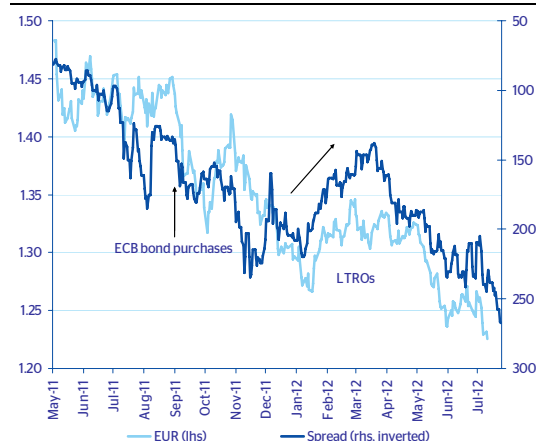
In the case of the US, the downward revision to our outlook for 2012 and beyond has been driven by a combination of disappointing growth figures in 1H12 and the impact of financial stress from the euro area. Emerging economies are likely to be the main drivers behind the slight acceleration in global GDP growth that we expect for 2013. In Latin America, despite a generalised downward revision in growth forecasts compared with three months ago, estimates for Mexico (3.7% and 3.0% for 2012 and 2013, respectively) remain unchanged thanks to upbeat activity data in 1H12, the continuation of favorable financing conditions in the domestic market, and gains in competitiveness. In Brazil, growth forecasts have been significantly revised downwards (to 2.2% from 3.3% in 2012) due to the impact of the external environment and domestic issues such as the slowdown in credit markets and loss of competitiveness.

Chart 3
Financial stress indicator, BBVA Research (*)



Source: BBVA Research and EPFR
(*) Tracks the trend of a series of financial variables, including stock market volatility, interest rates and exchange rates, sovereign and corporate credit risk, and liquidity tensions. Source: BBVA Research

Chart 4
**USD-EUR and Spanish and Italian risk premiums
Average spread vs. 10Y Bund, bp; index 1 Jan 11=100**



Source: BBVA Research and EPFR

As for Asia, growth in the first half of the year slowed in China by more than expected. In line with the weaker global outlook, we have accordingly revised down our projections for 2012-13. Nevertheless, monetary and fiscal measures to support growth should lead to a pickup in China, with growth in 2013 rising to 8.3%, a half percentage point higher than in 2012. Elsewhere in the Asia region there is also room for policy stimulus to support growth. However, there are downside risks, including a more severe worsening of external demand and a continued slowdown in China, exacerbated by ongoing domestic financial fragilities.

Changing risk perceptions in developed and emerging markets

The risk scenario that dominates the forecast horizon (2012-2013) is more focused on the developed economies and in particular, on the eurozone. Emerging economies have more room to manoeuvre with fiscal and monetary policies, and also have, overall, lower accumulated imbalances. There have been increasing capital flows from Europe into the US and the emerging markets, including those in Latin America. Since the end of May, when markets started pricing in that the US economy was running out of steam, yields on bonds that are traditionally regarded as risk-free sovereign assets (i.e., US and Germany) have fallen to historic low levels. Doubts surrounding the ability to reach a rapid solution of the euro crisis have been pressing in the same direction. But there are risks to the sustainability of this scenario.

2. Asian growth slowing on EU impact

Having passed the midway point of 2012, Asia's growth slowdown shows few signs of abating. Growth outturns in the second quarter continued to slow (Chart 5), primarily due to further weakness in external demand stemming from the uncertain global environment as described above in Section 1. This, in turn, is increasingly dampening consumer and business sentiment, with knock-on effects to domestic consumption and investment. While growth in the region remains relatively resilient – thanks to strong underlying economic fundamentals and growing intraregional trade – policymakers have appropriately been stepping up their stimulus measures to counter the external weakness.

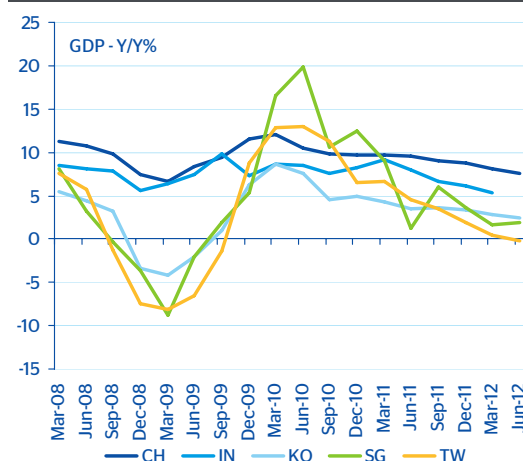
In addition to external prospects, investors and policymakers are keeping a wary eye on the slowdown in the region's larger economies, most notably China and India. In the second quarter, China posted its lowest quarterly growth outturn since 2009, of 7.6% y/y (1.8% s.a., q/q) as both exports and domestic demand weakened. For its part, India's growth fell in the first quarter to 5.3% y/y, its slowest in almost ten years, driven by weakness in private consumption and a deterioration in the investment climate as a result of the slow pace of policy reforms (see Box 1 on page 11). In contrast, growth in Indonesia remains robust, rising to 6.4% y/y in the second quarter despite a slowdown in exports, due to strong domestic demand and record FDI inflows.

As expected, growth has been slowing even more markedly among the region's more open economies. In Korea (2.4% y/y) and Singapore (1.9% y/y), for example, second quarter GDP growth remains well below trend. Meanwhile, the region's commodity exporters are feeling the effects of weaker external demand and lower commodity prices: Indonesia's trade balance has shifted to deficit in recent months, following similar trends in Australia (Chart 6).

With growth slowing and commodity prices coming off their highs of earlier in the year (notwithstanding a recent rise in prices of soft commodities due to global weather conditions), inflation has receded as a concern. This has enabled policymakers to shift their attention to supporting growth. China, India and Australia all cut their policy rates in the second quarter, while in July Korea cut rates for the first time since 2009 and the Philippines brought its own rate to a historic low of 3.75%. At the same time, weakening exports and capital inflows have led to a slowing of currency appreciation, or even a reversal toward depreciation, most notably in the Chinese RMB. Meanwhile, fiscal stimulus is being stepped up in a number of countries, including Korea and China. More policy easing is likely in the months ahead, as we expect growth to remain weak until at least the fourth quarter of 2012.

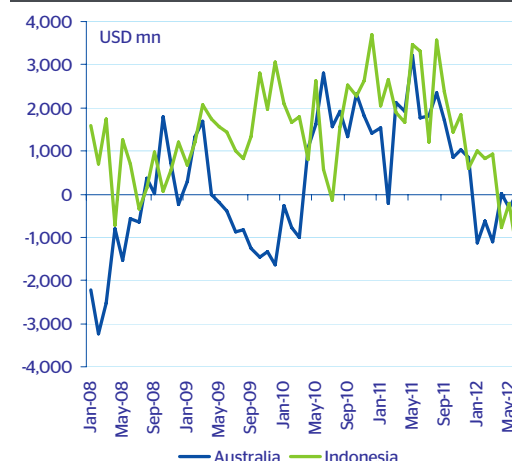
Heightened global risk aversion and weak financial market conditions are leading some countries to accelerate capital account liberalization plans. Notably, China has expanded its QFII program for inward RMB investment, while the authorities have also opened the domestic interbank bond market to certain foreign investors, including central banks. At the same time, China's outward non-financial foreign direct investment continues to rise rapidly, up by almost 50% y/y in the first half of 2012. In May and June, India announced several initiatives to further open its financial account for foreign investment, and on the trade front, China, Korea and Japan announced in May they will begin talks on a free-trade agreement in the second half of the year.

Chart 5
Asia's GDP growth is slowing on global headwinds



Source: CEC and BBVA Research

Chart 6
Trade balances in deficit



Source: CEIC and BBVA Research

Asia's growth momentum slows at a faster-than-expected clip...

Since our last *Quarterly Outlook* published in May, the fallout of the European crisis on external demand has caused Asia's growth momentum to slow by somewhat faster than previously expected. In particular, weak external conditions have spilled over to domestic demand. GDP growth in China (7.6% y/y) and Korea (2.4% y/y) continued to slow in the second quarter, with the outturns below previous expectations. Singapore showed a slight pickup on an over-year basis (to 1.9% y/y from 1.4% in 1Q), but it posted a contraction on a sequential basis (-1.1% q/q annualized), on sluggish exports. The weak outturns and diminishing prospects of a rapid revival in external demand have led policymakers to cut their official growth forecasts, such as in Indonesia (to 6.1%-6.5% from 6.3%-6.7%) and Korea (to 3.0% from 3.5%).

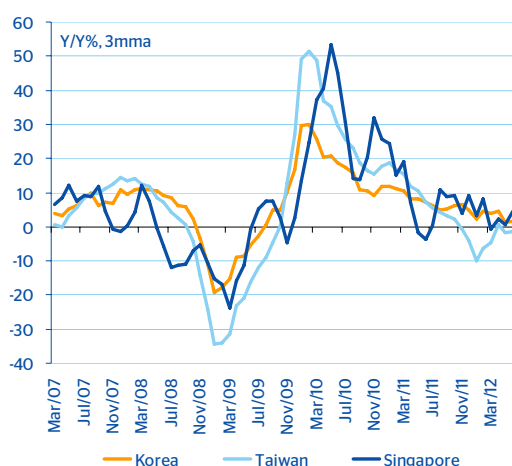
The slowdown is especially evident in the latest trends in industrial production (Chart 7), which have fallen sharply on a year-over-year basis for major manufacturing hubs such as Korea (1.5% y/y), Taiwan (-1.5% y/y) and Singapore (4.5% y/y). Japan's industrial production has faltered recently, even as the country rebounds from last year's earthquake. In Singapore, where IP outturns are notoriously volatile, June (7.6% y/y) showed a marked improvement from earlier in the year, but production growth is expected to remain sluggish in the coming months due to the weak external environment. Meanwhile, manufacturing PMIs have also been trending downward (Chart 8). Korea's PMI (49.4) fell below the 50 expansion/contraction breakeven in June for the first time since January, on weak new export orders, and Australia's PMI fell by 6.9 points in July to 40.3 due to concerns about demand.

...but remains resilient from intraregional trade and domestic demand

Given the severity of the weakness in the external environment, however, the resilience of Asian economies is impressive. One factor, as noted in our previous *Quarterly Outlooks*, is the growing contribution of intraregional trade (accounting for about 65% of total trade) and trade with other emerging markets in Latin America and Africa (accounting for around 15% of total trade) in supporting growth (Charts 9 and 10). Though Asian exporters still rely heavily on Chinese demand, much of it related to inputs for production of exports ultimately destined for overseas markets in the US and EU, over time the share of exports to ASEAN economies has increased. For example, high-end producers such as Korea have seen their share of exports to ASEAN increase from 11% to 14.5% since 2007. The same is true for the Philippines – as its exports have grown over the last four years, the trade share of goods being sent to other ASEAN nations has gone from 8% to 22.5%.

Chart 7

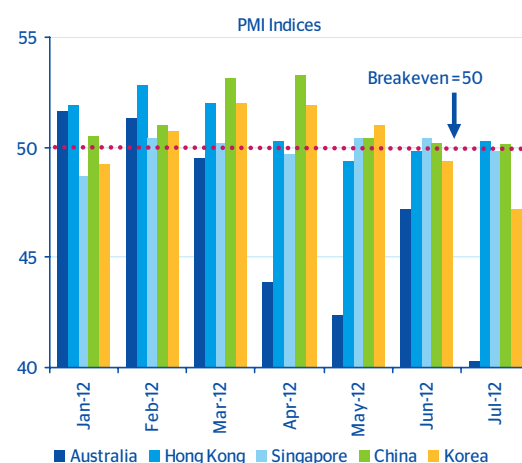
Industrial production has weakened with falling exports ...



Source: CEC and BBVA Research

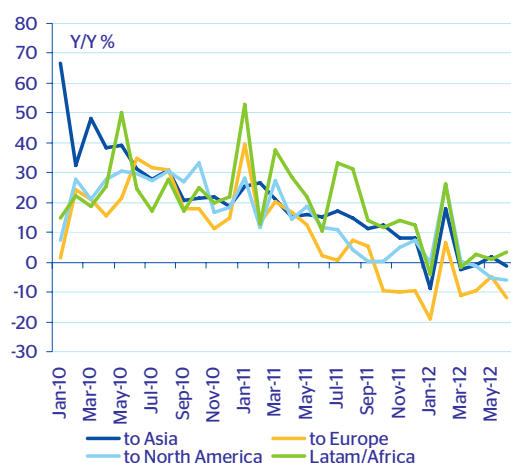
Chart 8

...and PMIs suggest the outlook remains subdued



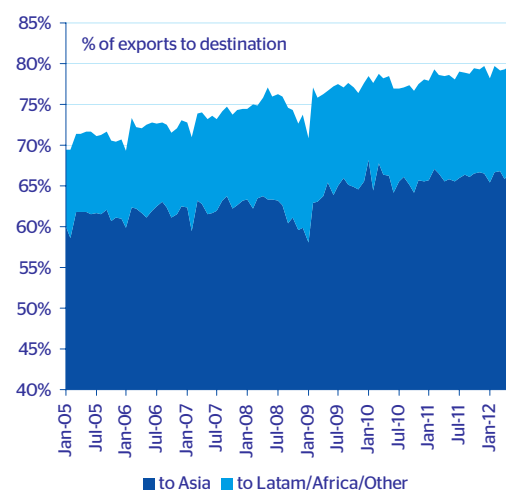
Source: CEIC and BBVA Research

Chart 9
Though European and US demand has softened, trade with emerging markets has been resilient



Source: CEIC and BBVA Research
*Data includes HK, KO, SG, TW

Chart 10
Emerging markets represent an increasing share of Asia's exports



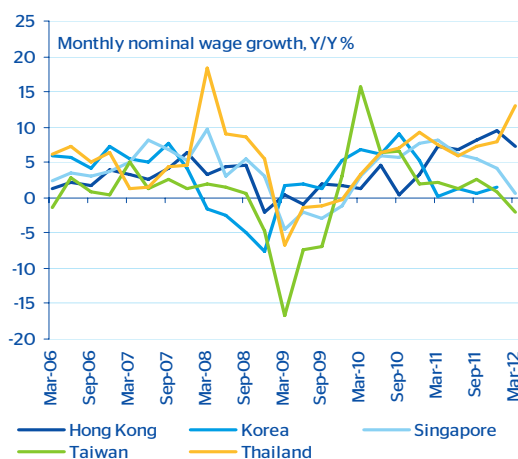
Source: CEIC and BBVA Research
*Data includes HK, KO, SG, TW

These trends have been particularly noticeable this year, as trade with the EU, US, and even China has slumped. For Korea, export growth to ASEAN grew by 20.2% y/y through June, even as exports to the EU, US, and China all contracted. For Taiwan - which has particularly felt the effects of deteriorating demand from China and the US for machinery and electronics (these two sectors represent a combined 48% of its exports) - year-to-date growth in exports to ASEAN, Australia, and Japan has remained positive.

Intraregional demand has also remained resilient for commodities producers like Malaysia and Thailand. In fact, exports within ASEAN for both Malaysia and Thailand have grown sharply, by 16.4% and 12.6% y/y in May respectively. This is important for these two countries, as shares of exports to ASEAN have historically remained above 25% - which gives Malaysia and Thailand more cushion from flagging China demand than for Taiwan and Korea. Overall, however, the strengthening of intraregional trade has not been enough to fully offset the drop in European and US demand.

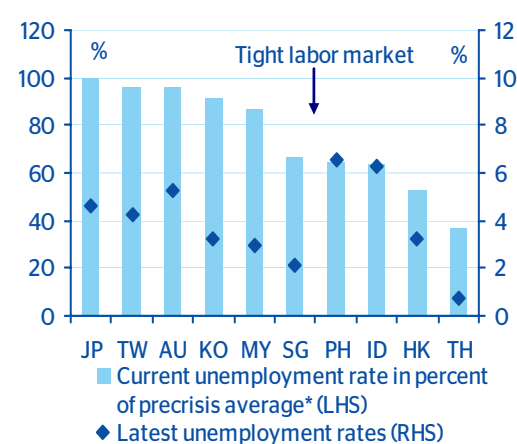
Another factor supporting the relative resilience of Asian economies is robust labor markets. Wage growth has broadly slowed of late (Chart 11), but recent years of steady wage increases and tight labor markets (Chart 12) are helping to sustain domestic consumption and overall domestic demand (Chart 13).

Chart 11
Nominal wage growth has slowed...



Source: CEIC and BBVA Research

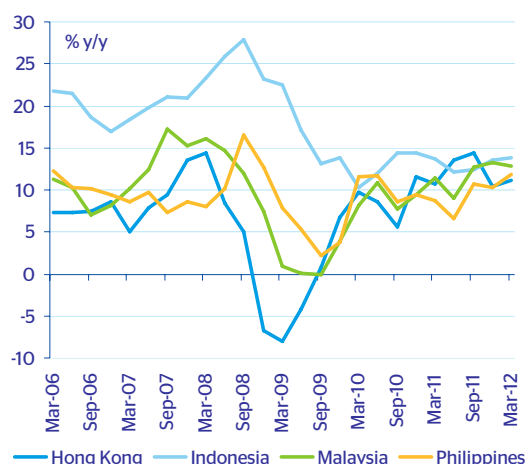
Chart 12
...despite tight labor markets...



Source: CEIC and BBVA Research

Chart 13

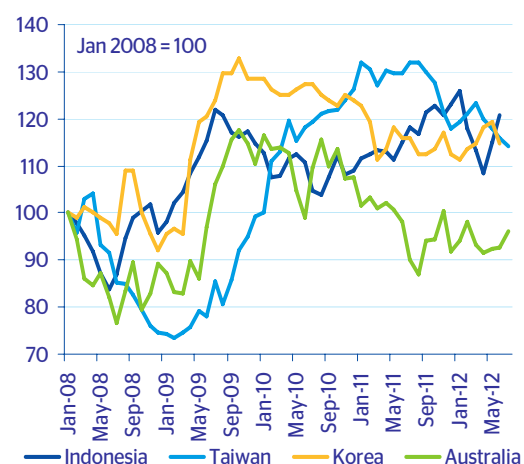
...continuing to support final domestic demand...



Source: CEIC and BBVA Research

Chart 14

...though weakening consumer sentiment clouds the outlook



Source: CEIC and BBVA Research

That said, domestic demand is now coming under pressure as consumer sentiment weakens (Chart 14), though there is some heterogeneity across the region. On the one hand, retail sales in Australia climbed for the sixth straight month in June, after strong job data for the January-to-May period. Japan's June retail sales grew by 0.2% y/y after surprising to the upside in May (+3.6% y/y) as government incentives boosted automobile sales, in addition to the positive effects of ongoing reconstruction spending. However, retail sales in the more open economies such as Singapore and Korea have slowed rapidly (Chart 15). Sales at Korea's top department stores (-2.0% y/y) and discount stores (-7.2% y/y) shrank on a year-over-year basis in June. Meanwhile, retail sales also slowed in Indonesia (to 8.0% y/y in May from 11.7% y/y in April) despite robust consumer sentiment. Investment has also slowed, especially in China and India; although it remains strong in Indonesia and the Philippines.

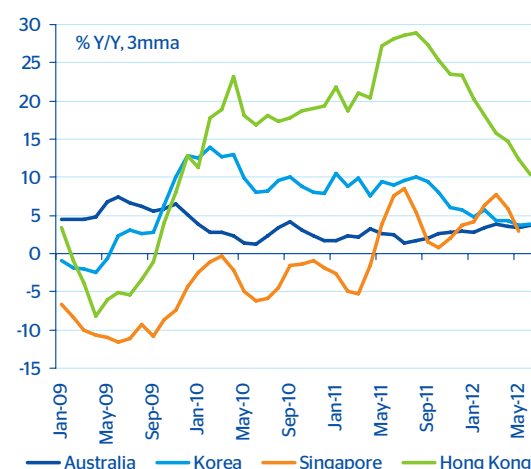
Current account surpluses are narrowing

The combination of somewhat resilient domestic demand and weakening exports has led to a narrowing of current account surpluses. For much of the region, structural surpluses have been too high, such as in China, and a narrowing of surpluses is a welcome development for its contribution to the correction of global imbalances and rotation of growth toward reliance on domestic demand. However, in a few cases, widening current account deficits may pose problems. In India, where the current account deficit widened from -2.7% of GDP in FY11 to -4.5% in FY12, downward pressure on the currency has been a source of concern. Expectations that a weak rupee would boost India's exports have yet to materialize as June exports posted a -5.5% y/y decline.

Indonesia's current account has also recently come under pressure due to weak external demand and falling commodity prices, with the country posting a significant decline in exports in June (-16.4% y/y). Despite the economy's sound underlying fundamentals and strong growth momentum, these factors have resulted in a trade deficit for the first time since July 2010. As with India, this has contributed to recent currency weakness, forcing the central bank to intervene in order to stem volatility in the rupiah, thereby reducing Indonesia's foreign reserves.

Chart 15

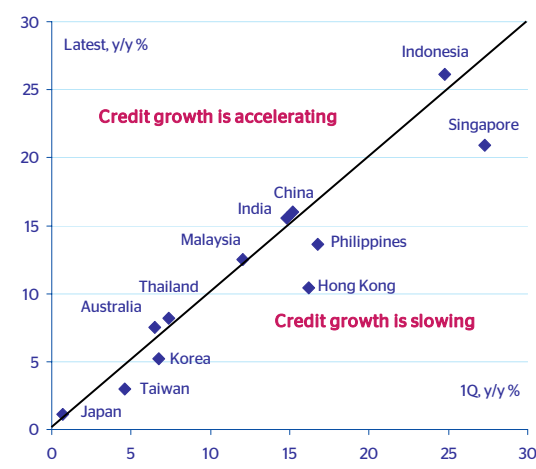
Retail sales have trended lower in the more open economies



Source: CEIC and BBVA Research

Chart 16

Credit growth has slowed the fastest in major financial centers Hong Kong and Singapore



Source: CEIC and BBVA Research

Only minor effects so far from the Euro crisis on regional credit trends

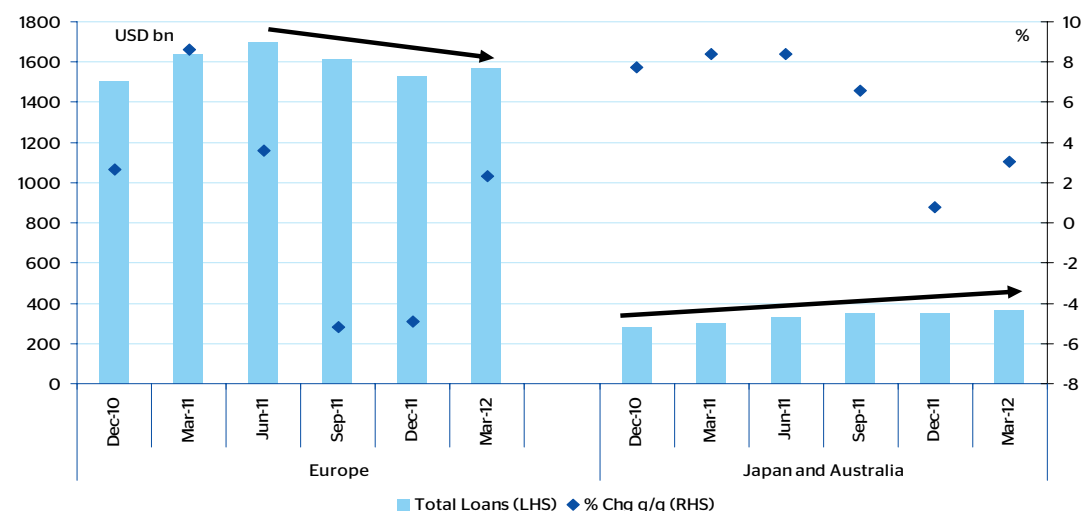
According to the latest BIS data (Chart 17), European bank lending to Asia rose on a q/q basis in the first quarter of 2012, although the upturn may well reflect seasonality (historically, bank lending accelerates in the first quarter of the year). Despite the positive sequential trend, however, Asia has seen a noticeable decline in credit flows from European banks since June of last year (-7.7%, see Box 2 on page 12). The countries most affected by this deleveraging include Korea (-11.5% y/y), Taiwan (-32.2% y/y) and Australia (-17.5% y/y).

Importantly, regional lenders, particularly from Japan and Australia where liquidity remains ample, appear to have stepped into the void, thus preventing a significant slowdown in overall credit growth.

However, trends in overall lending in the region are mixed, slowing the fastest on a year-over-year basis in the major financial centers of Hong Kong and Singapore, as well as in the Philippines (Chart 16). To some extent, the slowdown is welcome given previous credit growth rates that were deemed excessive. Meanwhile, in other countries such as Indonesia (26.1% y/y in May) and Malaysia (12.5% y/y in May) credit growth has remained high, a trend which is expected to continue in the near-term. Similarly, credit growth in China shows signs of picking up as the authorities loosen financial conditions in support of growth.

Chart 17

European lending rebounded slightly in Q1, while regional lending continued to expand



Source: BIS and BBVA Research

Box 1: India: in the crosshairs as growth slows

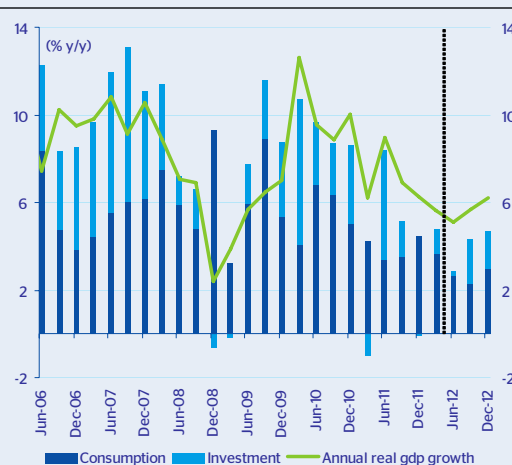
Among the region's larger economies, India has been experiencing the most severe slowdown. A combination of twin deficits in the current and fiscal accounts have undermined investor sentiment which, along with global headwinds, have contributed to a deceleration in India's growth momentum. First quarter GDP growth was the lowest in nine years (5.3% y/y), driven by a slowdown in the services sector and a contraction in manufacturing activity. The drag on the services sector, which accounts for about 60% of India's GDP, gained force in the second quarter. Agricultural growth has disappointed as well. Further, a deteriorating investment climate, rising food prices, and infrastructure bottlenecks (evidenced by recent electricity blackouts) are taking a toll on consumer and business confidence.

A steep deceleration in investment growth (Chart 18) has been the key factor behind India's slowdown. While steps have been taken in recent months to implement reforms to boost investment and attract foreign capital, the pace has been too slow. Reforms are needed in the sectors of power generation, mining, and manufacturing, along with land acquisition, among other areas. Since November 2011, several policy measures have been undertaken to enhance foreign investment flows - for example, in early July the RBI raised foreign institutional investor (FII) limits on government debt and infrastructure borrowings. However, these measures have generally fallen short of market expectations.

Given that most real activity indicators have slowed sequentially since the first quarter, it is likely that India's growth will turn out to have been even lower in the second quarter, especially given below normal rainfall from a weak monsoon season.

Fortunately, a sharp fall in oil prices and lower gold demand are likely to stem the rise in the current account deficit. Regarding the capital account, while FII flows have picked up in recent months, the slowdown in FDI flows remains a concern, thanks to domestic policy delays. We expect the Reserve Bank of India and finance ministry to continue with further measures to enhance inflows, including new rules permitting dollar bond issuance and dollar swap lines. A weak rupee may eventually provide a boost to exports, helping India regain its growth momentum, though this will be largely dependent upon the external environment.

Chart 18

India's falling investment growth has dragged down GDP

Source: CEIC and BBVA Research

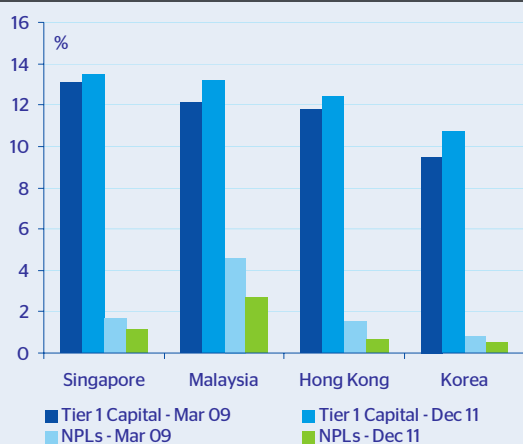
Box 2: European bank deleveraging offset by regional lenders

As the sovereign debt and financial crisis continues to grip Europe, European bank loans to Asia have contracted. Loans to Asia from French and German banks have decreased for two consecutive quarters, falling by -17.2% and -16.0% y/y in the first quarter alone (the most recent period for which BIS data are available). Within Asia, Korea and Taiwan have perhaps been the hardest hit, with loans from European banks (including the UK) contracting by 11.5% y/y and 32.2% y/y, respectively, in the first quarter (Korean borrowings from France have dropped 38.2% year-on year.)

However, elsewhere in the region credit growth of European banks has remained positive, including in Japan, Singapore, Hong Kong, and China. China in particular has continued to see robust loan growth from Europe (17.2% y/y in 1Q12).

Chart 19

Overall, regional banks have improved their balance sheets since the financial crisis



Source: CEIC and BBVA Research

Despite the recent trend of deleveraging by other European countries, loan growth from the UK, which represents over half of European loans to Asia, remains relatively strong at 4.1% y/y 1Q12. Lending from Japanese banks has been even stronger, with loans to the region growing 13.2% y/y in the first quarter of this year. Australia, too, has continued to step up intraregional lending, with loan growth over 18% on year to each of its Asian counterparties in the last recorded quarter. This, along with relatively strong lending from the US, has helped offset some of Europe's retreat in the region.

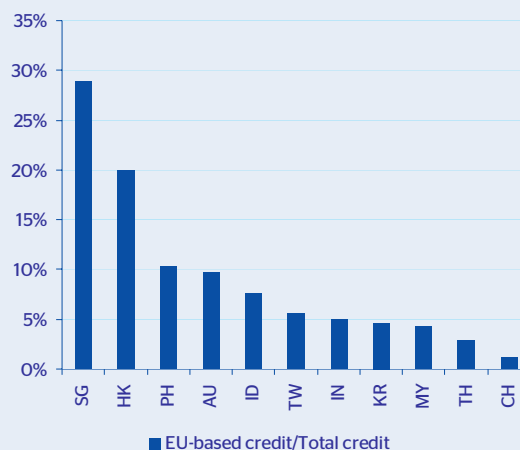
Looking ahead, the region's banks appear to be well prepared to withstand further European deleveraging. The drawn out nature of the European crisis has given regional banks and their customers ample time to prepare. In general, Asian bank balance sheets remain strong (Chart 19). Tier 1 capital levels in Singapore (13.5%), Malaysia (13.2%), Hong Kong (12.4%) and Korea (10.7%) are already above Basel III requirements, and delinquency rates are low.

That said, the greatest impact will likely be felt in the financial centers of Hong Kong and Singapore, given their high levels of borrowing from European banks (Chart 20). Elsewhere, though India relies on European banks for more than half of its foreign bank borrowing, as a percentage of total credit these European loans amount to only 5%, thus limiting the expected overall impact of European bank deleveraging on domestic credit availability.

Thus far, the drop in loans from European banks to the region is small relative to that seen during the global financial crisis. From the peak in 2Q08 to the trough in 1Q09, Europe's loans to Asia dropped by \$547 billion, while so far loans have only fallen by \$102 billion to the region since the recent peak in the second quarter of 2011. Asia may continue to see further deleveraging from Europe, but local banks appear more than willing to capture market share.

Chart 20

HK, SG have the highest credit exposures to Europe* in the region

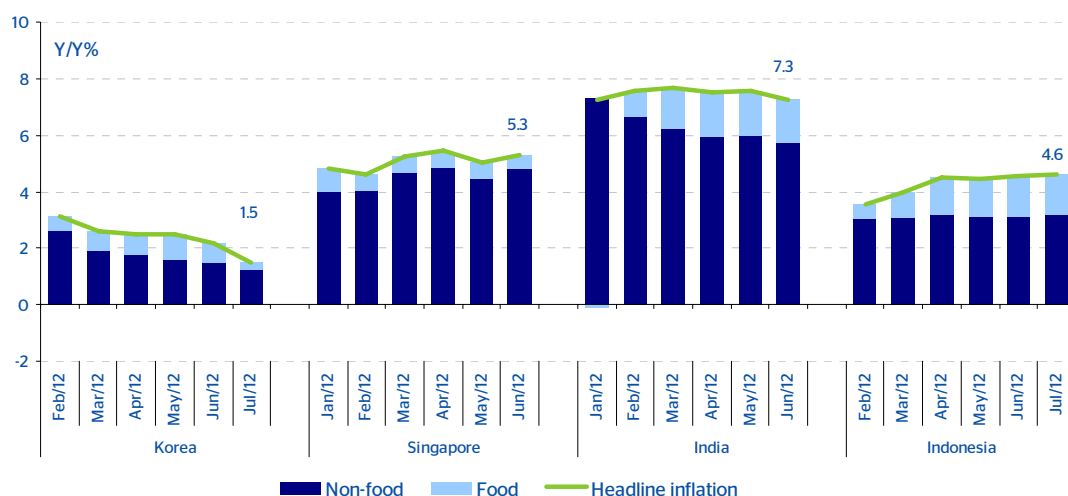


Source: CEIC and BBVA Research

*Figures exclude the UK

Chart 21

Other than India and Indonesia, the region has broadly seen lower food prices causing lower inflation



Source: CEIC and BBVA Research

Inflation has receded on weaker growth and lower commodity prices

Inflation has broadly fallen throughout the region in the second quarter, providing policymakers with room for further easing. There have been some exceptions, however, as inflation remains stubbornly high in India (7.3% in June), as well as in Singapore (5.3% y/y in June) where a tight labor market and its 'safe haven' status have caused increasing pressure on housing and transportation costs. Indonesia's inflation is rising (4.6% y/y in July), mostly from base effects but also due to persistent food price pressures (like India – see Chart 21), though policymakers expect inflation will remain comfortably within its 3.5%- 5.5% target range this year.

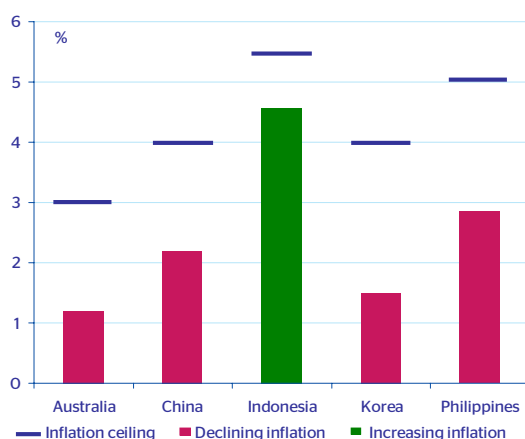
Several other countries such as Australia and the Philippines now have year-over-year inflation rates that are within or below official target ranges (Chart 22), largely due to falling energy prices and reduced demand pressures. China (2.2% in June), Hong Kong (3.7% y/y in June), and Korea (1.5% in July) have experienced welcome respites from last year's high inflation.

Japan's deflationary environment continues to be an outlier. The Bank of Japan has been seeking to stoke inflation in line with its recently adopted 1% target and asset purchase program. Efforts are also underway to help exporters by engineer some weakening of the yen, which has been relatively strong (remaining below 80/USD) due to heightened global risk aversion.

With oil prices having fallen sharply in the second quarter and global growth expected to remain muted, price pressures are expected to remain at bay in the coming months.

Chart 22

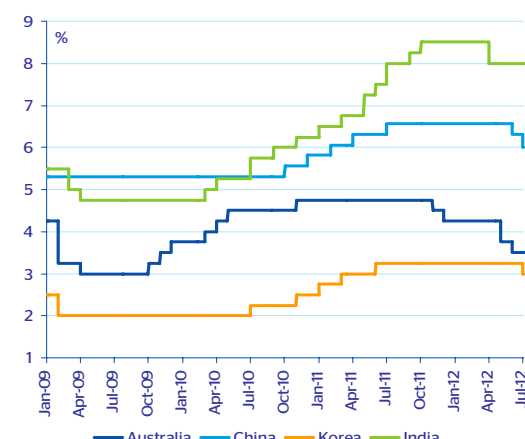
Inflation rates that are well below government ceilings leave room for further policy support



Source: CEIC and BBVA Research

Chart 23

Policymakers have been easing rates in order support growth



Source: CEIC and BBVA Research

Policymakers are responding with fiscal and monetary instruments

In recent months, Asian fiscal and monetary authorities have been calibrating their policy stances to the perceived severity of the global slowdown and its impact on their economies. As such, policies have turned increasingly expansionary, particularly on the monetary front. India (50bps), Australia (75bps), China (56bps), Korea (25bps) and the Philippines (25bps) have all cut interest rates since March (Chart 23), while Indonesia and Thailand have cut rates earlier in the year. Australia surprised the market with a larger-than-expected 50bp cut on May 1, citing a combination of weaker-than-expected economic conditions, lower-than-expected inflation, and efforts to ensure an 'appropriate level of borrowing costs.'

The decision by the Reserve Bank of India to cut rates by 50bps in April took markets by surprise, as expectations were for a 25bp cut. For China and Korea, rate cuts came earlier than expected, suggesting that authorities are taking a proactive approach to deteriorating external conditions given room from falling inflation in both economies. As mentioned above, Japan expanded its asset purchase program in April, by ¥5 trillion to ¥70 trillion, marking the second round of quantitative easing since February.

Despite the cuts in nominal rates, real interest rates are now more positive than a year ago due to the sharp declines in inflation. Interest rate levels are also generally above the lows reached during 2008-09. As such, there is room for further cuts as needed to support growth.

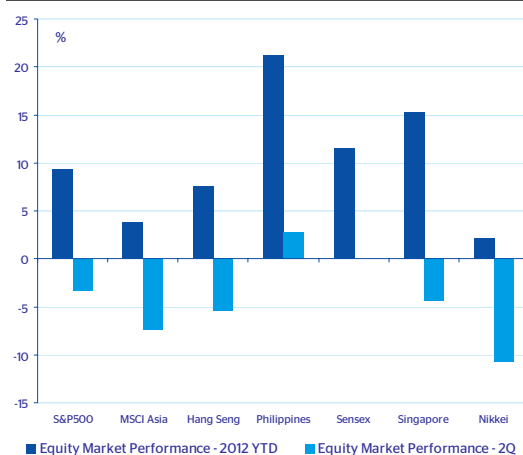
On the fiscal side, low debt-to-GDP ratios have allowed most countries to adopt expansionary policies. For instance, the recovery from last year's flooding in Thailand has been supported by significant expansionary fiscal policies, including a corporate tax rate cut from 30% to 23% (with a further lowering to 20% planned for 2013), a diesel fuel excise tax cut, a rice price intervention program, and subsidies for car buyers. The government has also raised civil servants' salaries and introduced an increase in the minimum wage in April for Bangkok, to be extended to the rest of the country next year.

Malaysia has enacted several measures to increase spending this year, including raising civil servants' salaries, giving cash handouts to low-income households (totaling a potential USD 72 billion) and farmers, and boosting spending on roads and railroads. The government is also subsidizing fuel prices and is now considering yet another round of cash handouts in August. This increased spending comes at a price, however, as it has resulted in a deteriorating fiscal position and an increase in gross debt (-5.0% and 52.5% of GDP, respectively, according to the IMF), prompting S&P to warn that a downgrade of Malaysia's sovereign debt would follow if measures to increase revenue are not taken.

Korea also introduced US\$7 billion in stimulus through better efficiency in executing approved projects, as well as creating a fund to finance facility investment by small-and-medium enterprises. Japan's efforts to improve its deteriorating fiscal position were given a boost as the lower house passed a bill that would hike its consumption tax from its current 5% to 8% in April 2014, then to 10% in October 2015. With spending from post-earthquake reconstruction adding further strain to the country's finances, the consumption tax increase is seen as a much-needed revenue boost, and will move to the upper house now for vote, where prospects are uncertain.

Chart 24

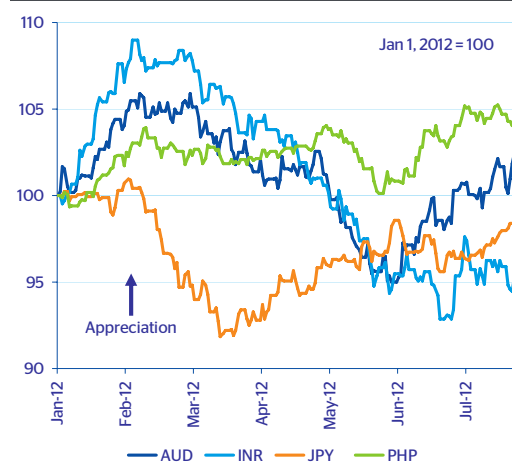
Despite the global turmoil, some regional equity markets have posted strong performance



Source: Bloomberg and BBVA Research

Chart 25

Volatile currency movements in 2012, with INR reaching historic lows



Source: Bloomberg and BBVA Research

Asian markets: high volatility, uncertain outlook

As elsewhere in the world, Asian equity markets have been highly volatile this year. While the region's markets have generally underperformed the S&P500, certain markets have seen substantial gains. At the end of July, the Philippines market was up 21.2% – reflecting among other factors an S&P sovereign rating upgrade in July – while Singapore's index advanced by 15.3%, and India's Sensex rose by 11.5%, despite all of the negative sentiment surrounding its slowing growth and sluggish pace of policy reforms. Most of these gains occurred in the first quarter, as markets broadly sold off in the second quarter (Chart 24). The recent selloff was caused by a combination of fears over the European crisis, a sharper slowdown in China, and weakening US data.

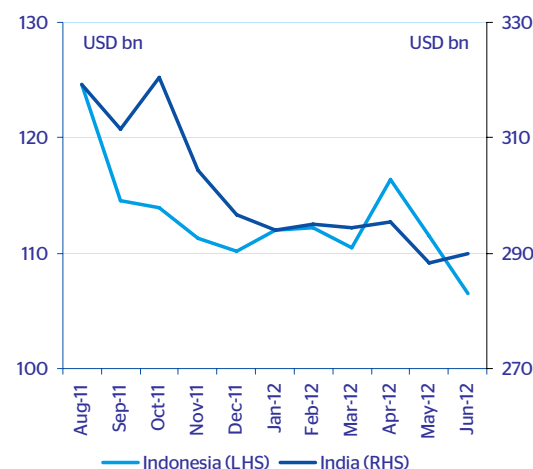
FX markets have also been highly volatile in the second quarter (Chart 25), marked by a weakening trend due to sluggish external demand. A rapid selloff in May was immediately followed by a rebound in the early part of June on prospects of further easing by the US Fed and ECB, which continued through July. The Indian rupee has attracted the lion's share of attention, as it reached historic lows in late June due to weakening fundamentals and increasing dollar purchases by domestic oil and gold importers. Since then, the rupee has rebounded as global conditions improved somewhat. Central banks have been actively utilizing reserves (Chart 26) to smooth the volatility: since August of last year, Indonesia's reserves have declined by 14.6% (and now stand at US\$ 106.5 billion), while India's reserves have declined by 9.1%.

Overall, the region's best performing currencies this year have been the Philippines peso (+4.9%) and Singapore dollar (+4.3%). The peso's recent strong performance (it reached a four-year high on July 3rd) has caused authorities to consider taking measures to curb excessive currency speculation (such as tougher rules on capital inflows through non-deliverable currency forwards) in order to keep the currency from strengthening too quickly, which would adversely impact exporters. As noted above, in Japan, despite the authorities' attempts to weaken the currency through quantitative easing, the yen has strengthened in the second quarter.

Despite heightened risk aversion, property markets in Singapore and Hong Kong continue to rise (Chart 27). In Hong Kong, demand for office space remains robust, despite market concerns that the social housing policies of the new Hong Kong administration may eventually suppress prices. In Singapore, property prices reached a new record high, rebounding by 0.4% in the second quarter after falling by 0.1% in the first quarter. In spite of the government's efforts to curb house price increases (a 10% tax on residential property purchases in December), Singapore has become firmly entrenched as a 'safe haven' destination for foreign buyers. However, property prices have been under pressure elsewhere in the region, falling in Korea by 0.7% year-to-date, as well as in China, where June property values rose by 0.1% m/m after having fallen for ten consecutive months.

Chart 26

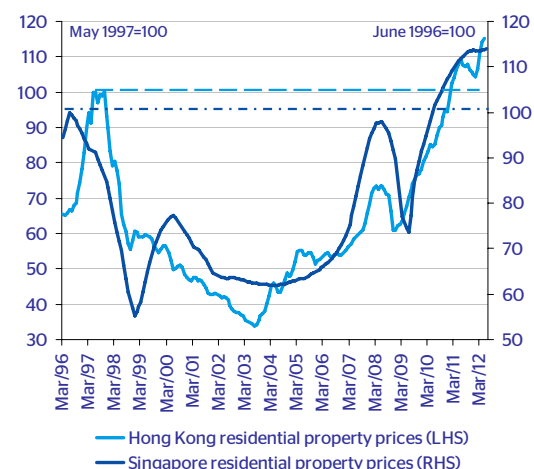
Central banks have been using reserves to stabilize their currencies



Source: CEIC and BBVA Research

Chart 27

Property markets have remained robust



Source: CEIC and BBVA Research

3. Lower growth projections from a weaker external environment

Against the backdrop of increasing global headwinds and uncertainties, we are revising down our 2012 and 2013 GDP growth forecasts modestly for the Asia Pacific region. Downside risks have increased further over the last quarter as described in Section 1, and as reflected in heightened global risk aversion. At the same time, we remain sanguine about Asia's ability to weather the worst of the turbulence given its internal strengths and limited direct financial exposure to the Eurozone, although growth rates would suffer as already seen from weaker exports. In the meantime, room for fiscal and monetary policy stimulus is a partial cushion to weakening external demand.

Downward revisions to 2012 and 2013 GDP forecasts

Weakening external demand and ongoing financial stress in Europe have made us less optimistic about an early rebound of growth in Asia. Our updated projections are based on a gradual resolution of the European crisis such that financial tensions in the Eurozone begin to ease by the fourth quarter. Together with the Asia region's stimulus measures, this should set the stage for a gradual rebound in growth toward the end of the year. This outlook, however, is subject to considerable downside risk.

We have revised down our full-year 2012 growth forecasts for the Asia Pacific region due to the weaker-than-expected H1 outturn and lower global forecasts for the remainder of the year and 2013. All told, our aggregate forecast for the region has been lowered to 5.4% y/y, from 5.7% y/y previously (Table 1), with somewhat larger revisions to our China and India forecasts. For 2013, we are revising our Asia Pacific growth forecast to 5.8% y/y from 6.1% y/y previously.

Our forecasts for China are now 7.8% y/y and 8.3% y/y in 2012 and 2013, respectively, down from 8.3% and 8.7% previously. We believe the slowdown in the Chinese economy has stabilized, and further stimulus measures should ensure a gradual pickup during the remainder of the year. In India, growth momentum remains relatively weak, and we have lowered our forecasts to 5.6% y/y and 7.1% y/y in 2012 and 2013, from 6.8% y/y and 7.4% y/y previously, on the expectation that the reform momentum will gather pace in 2013.

Due to persistent weakness in external demand we also anticipate further slowdowns in some of the more export-oriented economies in 2012, particularly Hong Kong (2.1% y/y, from 3.1% y/y), Korea (2.5% y/y) and Taiwan (2.0% y/y from 3.2% y/y). For Singapore (2.6% y/y), our 2012 forecast remains intact for now, but there are heightened downside risks to that projection.

We have also made a few upward revisions in 2012, including for Japan (2.4% y/y from 1.9%), reflecting its strong rebound from last year's earthquake, although the strength of the longer term outlook remains questionable due to Japan's high debt level and aging population (reflecting a recent Fitch sovereign downgrade to A+ from AA). We are revising our projection for the Philippines upwards to 4.8% y/y from 3.7% y/y after first quarter growth came in well above expectations due to robust government and private consumption; and Thailand (5.0% y/y from 4.5% y/y), which has rebounded quickly after last year's floods.

Inflationary pressures to stay muted given the weak global environment

While headline numbers are expected to rise modestly in the latter part of the year due partly to base effects, inflation is no longer a key concern. Domestic demand has been weakening and a sluggish external environment should ensure that inflationary pressures remains contained through the end of this year (Table 2). Accordingly, we have revised our regional inflation forecast down to 3.3% y/y in 2012 (from 3.5% y/y), reflecting downward revisions for China (3.0% y/y from 3.5%), Hong Kong (4.3% y/y from 4.7%), Korea (2.5% y/y from 3.4% y/y) and Australia (1.9% y/y from 2.7%) by around 0.6 ppts on average to reflect the weak global environment and falling oil prices, which are helping to further alleviate inflation. In Indonesia (4.8% y/y from 5.4% y/y), a previously planned hike in fuel prices now looks unlikely, which will result in lower inflation for this year than previously forecast.

Inflationary pressures remain strongest in India (revised upward to 7.3% y/y in 2012, from 6.9%), where the weak rupee is pushing up energy costs, and in Singapore (4.1% y/y in 2012 from 3.3% y/y), where domestic demand still remains resilient.

Policymakers are more active, with additional rate cuts likely

The global slowdown has caused Asia's policymakers to react by cutting interest rates. On top of the rate cuts already made this year, we expect further interest rate cuts in China, India, Australia, Korea and the Philippines (Table 4) – and in China's case we will likely see 2-3 more cuts in the RRR as well. For other countries like Thailand and Malaysia, the possibility of rate cuts is also increasing, although they are not yet factored into our baseline.

For the remainder of the region, we expect policymakers to remain on hold through the end of this year, either to allow previous policy cuts to work their way into the economy (Indonesia), or, as in Singapore, due to still high inflation. Singapore surprised the markets by tightening monetary policy in April (Singapore manages its monetary policy through its exchange rate), and if inflation falls it may ease monetary policy (by slowing the pace of currency appreciation) at its next meeting in October, due to a significant slowdown in growth. Japan is likely to continue expanding its asset purchase program as it attempts to counter deflation.

Some of the 'heavy lifting' will likely have to be done through fiscal spending, where Asia retains significant room. China is likely to announce fiscal stimulus, and even India, which has limited room to increase its budget, has attempted to stimulate the economy by fast-tracking infrastructure investments, improving clarity on taxation, and raising FDI limits on various sectors. Other countries like Korea and Vietnam are likely to provide support, although it is expected to be more limited than that of 2009.

Asian currencies will be under short-term pressure

Asian currencies are expected to retain a slight depreciation bias in the coming months, as ongoing stresses abroad continue to weigh on regional risk assets. Weaker currencies will also provide some relief to domestic exporters. Nevertheless, under our baseline of a gradual pickup in growth toward the end of the year, we expect Asian currencies to rebound eventually (Table 3) on an improving global environment and prospects for further quantitative easing in the US. Despite lower interest rates, yield differentials between Asia and developed markets still remain attractive. Of special note, we have scaled back our expectations of RMB appreciation due to the sluggish global environment and weaker exports. We also expect the Japanese yen to depreciate in the later part of this year as global conditions improve somewhat and policy measures (including QE) cause a selloff in the yen. In our view, the rupee has reached a bottom and should remain relatively flat for the remainder of the year, ending 2012 at around 54 per USD. A gradual improvement in the country's fundamentals in 2013 will cause further appreciation to 51 per USD by the end of the year.

4. Downside risks to the outlook

After a relatively benign first quarter, global risks have increased substantially over the past quarter. While we continue to expect Asia to post reasonable growth rates in 2012-13, the outlook is marked by significant downside risks owing to the uncertain global environment. On the positive side, easing oil prices have offset some of the global headwinds.

In the event that the Eurozone crisis fails to abate, growth would be considerably lower in 2013 through a combination of weaker export growth and heightened risk aversion that would result in tighter financial conditions and weigh on investment. Relative to our baseline, regional growth would be lower by some 2 percentage points on average, with the more open economies such as Hong Kong more severely affected. An associated risk is the possibility of tighter financial conditions should European bank deleveraging accelerate.

Risks from within the region itself stem from the possibility of a further slowdown in China. Also, further spillovers to domestic demand from weakening exports, beyond those already envisaged in our baseline, cannot be discounted.

Country-specific risks are also worth monitoring. China will see a once-in-a-decade leadership change later this year. While we do not expect the process to result in policy shifts, the power struggle has already been somewhat more turbulent than expected. Also, Korea will hold a Presidential election in December. Meanwhile in India, it remains to be seen whether the government will succeed in restoring its reform momentum, which is crucial for a revival in investor sentiment and economic growth. Recent wide scale and paralyzing electricity blackouts are a reminder of India's lagging infrastructure, which are acting as a constraint to achieving higher medium term growth.

The political changes may exacerbate rising geopolitical tensions. In particular, regional disputes over the South China Sea persist among China, the Philippines, and Vietnam. Similar disputes are escalating in the East China Sea between China and Japan. In addition to undermining investor sentiment, these conflicts are increasingly causing pressures for further military build-ups which could divert fiscal spending from more productive investments.

5. Tables

Table 1

Macroeconomic Forecasts: Gross Domestic Product

(YoY% growth rate)	2009	2010	2011	2012 (F)	2013 (F)
U.S.	-3.1	2.4	1.8	2.1	1.8
EMU	-4.4	1.9	1.5	-0.3	0.3
Asia-Pacific	4.2	8.1	5.8	5.4	5.8
Australia	1.5	2.4	2.2	3.2	3.0
Japan	-5.5	4.4	-0.7	2.4	1.4
China	9.2	10.4	9.2	7.8	8.3
Hong Kong	-2.7	7.0	5.0	2.1	3.1
India	9.1	8.8	7.5	5.6	7.1
Indonesia	4.6	6.1	6.5	6.1	6.4
Korea	0.3	6.2	3.6	2.5	3.2
Malaysia	-1.6	7.2	5.1	4.2	4.9
Philippines	1.1	7.6	3.9	4.8	4.5
Singapore	-0.8	14.5	5.0	2.6	3.5
Taiwan	-1.9	10.8	4.0	2.0	3.8
Thailand	-2.3	7.8	0.1	5.0	5.1
Vietnam	5.3	6.8	5.9	5.6	6.5
Asia ex China	1.0	6.7	3.5	3.8	4.1
World	-0.6	5.1	3.9	3.4	3.7

Source: CEIC and BBVA Research

Table 2

Macroeconomic Forecasts: Inflation (Avg.)

(YoY% growth rate)	2009	2010	2011	2012 (F)	2013 (F)
U.S.	-0.4	1.6	3.1	2.0	1.9
EMU	0.3	1.6	2.7	2.3	1.4
Asia-Pacific	0.3	3.6	4.8	3.3	3.4
Australia	1.8	2.8	3.4	1.9	3.0
Japan	-1.4	-0.7	-0.3	0.2	0.1
China	-0.8	3.3	5.4	3.0	3.6
Hong Kong	0.6	2.3	5.3	4.3	3.6
India	2.4	9.6	9.4	7.3	6.3
Indonesia	4.8	5.1	5.4	4.8	5.2
Korea	2.8	3.0	4.0	2.5	3.0
Malaysia	0.6	1.7	3.2	2.3	2.7
Philippines	3.2	3.8	4.4	3.4	3.9
Singapore	0.6	2.8	5.2	4.1	3.2
Taiwan	-0.9	1.0	1.4	1.6	1.6
Thailand	-0.8	3.3	3.8	3.5	3.3
Vietnam	6.9	10.0	18.1	10.6	9.8
Asia ex China	1.0	3.7	4.3	3.4	3.2
World	2.2	3.0	5.1	4.2	3.9

Source: CEIC and BBVA Research

Table 3

Macroeconomic Forecasts: Exchange Rates (End of period)

		2009	2010	2011	2012 (F)	2013 (F)
EMU	USD/EUR	1.43	1.34	1.30	1.23	1.31
Australia	USD/AUD	0.90	1.02	1.02	1.04	1.06
Japan	JPY/USD	92.1	81.1	76.9	82.0	86.0
China	CNY/USD	6.83	6.61	6.30	6.31	6.13
Hong Kong	HKD/USD	7.75	7.77	7.77	7.80	7.80
India	INR/USD	46.60	44.71	53.06	54.0	51.0
Indonesia	IDR/USD	9395	8996	9069	9100	9000
Korea	KRW/USD	1166	1126	1152	1140	1100
Malaysia	MYR/USD	3.52	3.06	3.17	3.05	2.90
Philippines	PHP/USD	46.8	43.8	43.80	42.50	42.50
Singapore	SGD/USD	1.40	1.28	1.30	1.26	1.23
Taiwan	NTD/USD	32.3	29.3	30.28	30.20	29.90
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

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	0.75	1.00	1.00	0.75	0.75
Australia	3.50	4.75	4.25	3.25	4.00
Japan	0.10	0.10	0.10	0.10	0.10
China	6.00	5.81	6.56	5.75	6.00
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	5.75	5.75
Korea	3.00	2.50	3.25	2.75	2.75
Malaysia	3.00	2.75	3.00	3.00	3.00
Philippines	3.75	4.00	4.50	3.50	3.50
Singapore	0.40	0.48	0.45	0.40	0.40
Taiwan	1.88	1.63	1.88	1.88	1.88
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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