BBVA Research

Asia

Economic Outlook

First Quarter 2011

Economic Analysis

- GDP outturns across Asia have continued to surprise to the upside, furthering the region's role as an engine of recovery for the global economy. We expect strong growth to continue in 2011, albeit at a moderating pace, underpinned by strong demand from China and India.
- Inflation has rapidly become a concern across Asia due to rising food and commodity prices and, increasingly, demand pressures. We are raising our 2011 inflation forecasts for a number of economies; nevertheless, inflation levels should stay modest.
- Policy stances in the region have shifted toward maintaining price stability. We expect further monetary tightening, accompanied by currency appreciation and macro-prudential measures to stem capital inflows and to contain credit growth.
- Risks are tilted to overheating. Output gaps are closed, and capital inflows could exacerbate asset price bubbles. At the same time, downside risks stem from fragilities in industrial economies and further food and commodity price increases.

Index

Publication date: February 9, 2011

Summary

GDP outturns across Asia have continued to surprise to the upside, furthering the region's role as an engine of recovery for the global economy. Growth has been underpinned by strong demand from China and India, even in the face of subpar growth in the industrialized economies. Increasing intraregional trade and robust domestic demand are factors for Asia's strong performance, both of which appear set to continue.

Rising inflation has become the policy main concern across the region. Food and commodity price increases have generated inflation from the supply side, while the closure of output gaps and strong growth momentum are creating pressures from the demand side. Policymakers have, appropriately, shifted their focus from nurturing growth toward maintaining price stability, especially by tightening monetary policy. However, low international interest rates pose a policy dilemma for regional policymakers, since higher domestic rates are likely to attract capital inflows.

Our baseline projections continue to anticipate strong growth in 2011, but at a moderating pace, in line with potential. While the pace of growth has moderated from the strong bounce-backs of early 2010, fourth quarter momentum showed signs of picking up, and prospects for further strong domestic demand-led growth in 2011 are good. We therefore maintain our expectation of a resilient outlook for Asian economies in 2011, with growth of 4.8% for Asia ex-China, and 9.2% in China.

In view of recent trends, we are raising our 2011 inflation forecasts for a number of economies, including China, Hong Kong, Indonesia, Korea and Singapore, and Vietnam, while maintaining our outlook for moderate inflation in India. Nevertheless, our baseline projections incorporate relatively modest inflation levels give the moderating growth trends and an anticipated levelling off of commodity prices. Risks to the inflation outlook, however, are clearly to the upside.

Given the risks of higher inflation and policy dilemmas posed by higher interest rates, governments are implementing measures on a range of fronts. In particular, monetary tightening is being accompanied by macro-prudential measures to stem inflows and restrain credit growth, along with some allowance of further currency appreciation. On the supply side, a number of governments have implemented measures to stem food price increases and to soften the impact on vulnerable segments of the population.

Risks are tilted toward overheating. The closure of output gaps and prospects for strong growth momentum are generating demand pressures as seen in rising inflation. There is a risk that monetary policy may not be tightened fast enough or sufficiently to offset further inflationary pressures. Exacerbated by prospects for further capital inflows, risks of asset price bubbles also remain.

On the other hand, downside risks to the outlook are still present from fragilities to recoveries in industrial countries. Rising food and commodity prices could also undermine growth trajectories. Should downside risks materialize, however, most Asian economies would have room for further fiscal expansion to soften the impact.

1. Global outlook: decouplings at play

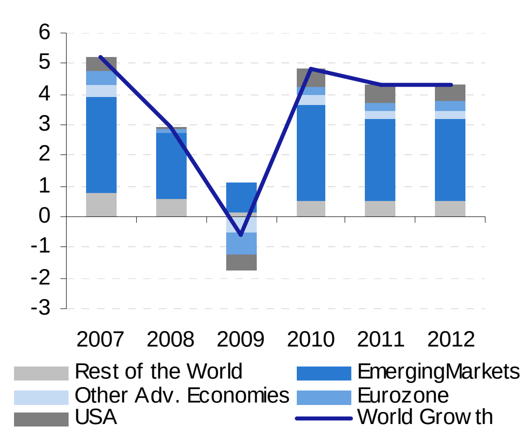
Before turning to Asia, we review the Global Economic Outlook

The global economy will continue on divergent paths

After closing 2010 with a growth rate of 4.8%, the global economy is expected to decelerate slightly to 4.4% both in 2011 and 2012, a better performance than anticipated 12 months ago. This is explained by an improved outlook for advanced economies, due to (i) better growth expectations for the US after the fiscal stimulus, and (ii) stronger performance in core European countries, which have decoupled from those of the periphery. In fact, even though financial market tensions in Europe worsened during the last quarter of 2010, economic activity in the region as a whole accelerated, showing–at least temporarily–a degree of decoupling as well between the financial and the real side. Overall, the pattern of global economic growth remains broadly unchanged as the main engine of dynamism continues to be the emerging world, led by Asia as discussed below (China and India in particular, see Chart 1), with developed economies continuing to lose ground.

Chart 1

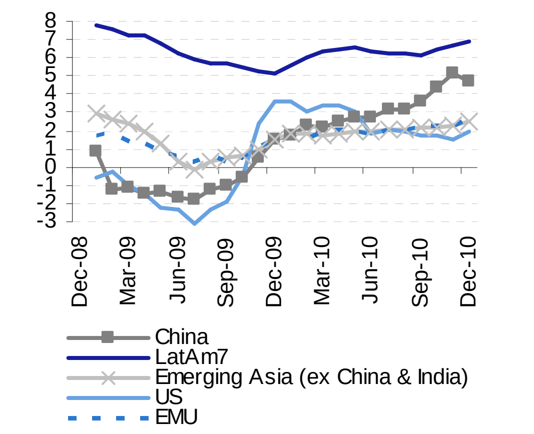
Global GDP growth and contributions



Source: BBVA Research

Chart 2

Inflation



Source: Datastream and BBVA Research

All these decouplings have three important implications for the outlook. First, the divergence between growth in advanced and emerging economies will continue to induce markedly different macroeconomic policies going forward. Monetary policies will remain highly accommodative in the US and Europe, fuelling a search for yield elsewhere (in emerging markets and increasingly in commodities as well). At the same time, signs of overheating are starting to emerge in some countries in Asia and Latin America, pushing authorities to consider tightening policy faster than previously envisioned given incipient inflationary pressures, especially in Asia (Chart 2). The resulting incentives for capital inflows into emerging economies will intensify policy dilemmas already present in both regions, between tightening policy to ensure a soft landing and preventing sudden and sharp exchange rate appreciations.

Second, the growth divergence between the US and EMU will–together with financial risk–put downward pressure on the euro and, perhaps more significantly, will keep drawing market attention to the relative difficulty of the EMU to grow out of their high public debt levels. This is one of the elements–together with the different size of central banks' bond-purchase programs and the turmoil around economic governance in Europe–that explains why markets have not reacted significantly to a further postponement of fiscal consolidation in the US.

Finally, the increasing decoupling within the EMU will start straining the conduct of a common monetary policy for the region, already torn between an incipient risk of inflation, especially in core countries, and the need to continue supporting financial stability, especially–but not exclusively–in peripheral economies.

Growth in the major advanced economies has picked up, but fragilities remain

As we anticipated, the US did not fall into a double dip, and the chances of that happening in the future have faded since the summer. Four main factors have contributed to the change in sentiment regarding the outlook for growth in the US. First, better macro outturns at the end of 2010 signaled that household consumption was more resilient than was feared. Second, decisive action by the Federal Reserve, implementing an additional round of asset purchases (QE2), provided support for bond prices in particular, and asset prices in general. Third, reduced uncertainty and increased business confidence is expected to benefit investment. Finally, and perhaps more important, a new fiscal stimulus package, approved at the end of 2010, will provide a significant boost to economic growth. We have thus adjusted our growth forecast for 2011 by 0.7 percentage points, to 3.0%.

However, weaknesses have not disappeared. Real estate markets remain feeble and are still prone to negative surprises. Household income is still sluggish given that the speed of the recovery will not be sufficient to significantly reduce unemployment rates. Furthermore, credit growth and securitization processes remain subdued. While none of this should derail the recovery, it may contribute to a scenario in which an additional negative shock could harm the economy. For now, this outlook of gradual economic recovery with low inflationary pressures on the demand side, should permit monetary policy to remain accommodative for an extended period.

Moreover, the lessons from the sovereign crisis in Europe should not be forgotten. Granted, the new fiscal package at the end of 2010 had the benefit of boosting growth in the short-run, at the time when doubts about a double dip were still in the air. But one should not overestimate the strength and persistence of the factors that have prevented a negative reaction from bond markets to a further delay of fiscal consolidation in the US. Central bank bond purchases and the turmoil in Europe (and thus flight to quality to US bonds) are by nature short-run factors that will disappear in the medium run, and before that happens, the US will need to show a clear commitment to fiscal consolidation.

Institutional and economic reforms in Europe will be crucial

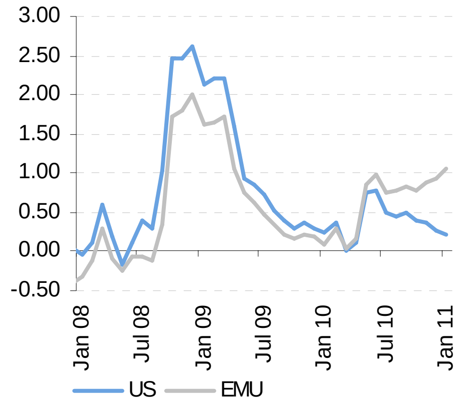
Since October 2010, financial tensions in Europe have surged again (Chart 3), especially in peripheral countries. Concerns about fiscal sustainability and financial sector losses have resurfaced, leading to widening sovereign spreads and funding pressures. However, contrary to the episode in May, financial spillovers to other countries in Europe and outside the EU were more limited.

The increase in financial market tensions was triggered by two events. First, markets were uncertain about the ability of European institutions to deal with sovereign debt crises. Private investors were spooked by the proposal that they would bear losses on possible restructurings after 2013, and the likelihood that haircuts on existing debt would be needed to restore fiscal sustainability. The second trigger was increasing doubts about the credibility of stress tests, given the need to support Irish banks shortly after they were deemed adequately capitalized. These two triggers developed amid the background of concerns about the capacity of some peripheral countries like Portugal and Ireland to fulfill their fiscal deficit targets and doubts about the ability of some European economies to generate enough growth momentum to make their debt burden sustainable.

The fragility of the recovery in financial markets after the summer highlights that markets are increasingly focused on sovereign solvency problems in some countries, rather than just liquidity concerns. This stresses the need for a comprehensive solution, both for solving this crisis, as well as establishing a sound crisis prevention and resolution mechanism for the future. For future crisis prevention, fiscal coordination needs to be reinforced, providing for shock absorbers for idiosyncratic shocks in individual countries, but also reinforcing surveillance both in the fiscal front and in the macroeconomic dimension (including preventing the build-up of private sector imbalances). For crisis resolution, a clear and transparent mechanism that defines those who will bear losses needs to be put in place, to avoid excessive market volatility due to uncertainty, but probably at this stage is extremely important to guarantee an adequate transition mechanism.

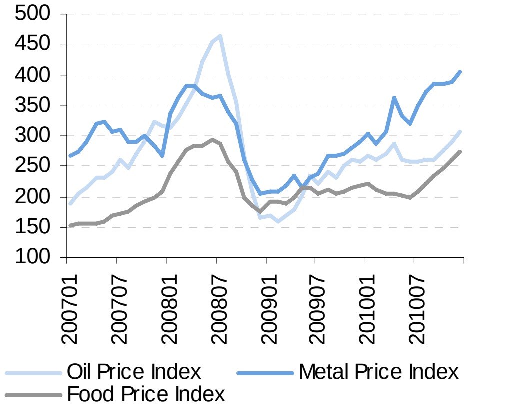
As pointed out above, financial spillovers from this recent episode have been rather limited, including to core countries in Europe. Thus, growth in the EMU as a whole was stronger than anticipated, especially due to positive outturns in Germany and other core European countries. However, this decoupling between financial tensions in peripheral countries and real economic activity in Europe will not last if a comprehensive governance reform is not agreed soon and countries do not continue pushing economic reforms to reduce fiscal vulnerabilities, restructure the financial system and increase potential growth. What is agreed at the next European Council in March will be key in this respect.

Chart 3
BBVA Financial Stress Index



Source: BBVA Research

Chart 4
Commodity prices



Source: BBVA Research

Commodity prices will level off, but inflation is a concern in emerging economies

Commodity prices have surged across the board in recent months, reaching all-time highs in the case of some metal prices (Chart 4). This is consistent with what seems to be the beginning of a long-term upward trend in commodity prices driven by surging demand from emerging economies, but there are other short-run factors that have contributed to the recent surge, at least in some commodity classes. For instance, the very fast increase in food prices in the past two months is to a great extent the effect of one-time supply-side factors (weather disturbances), which should wind down during the rest of 2011. Moreover, given ample global liquidity conditions, investors have piled into commodities as an asset class, increasing financial premia across the board.

Going forward, we expect commodity prices in general to level off around current readings. In the case of food prices this will be the result of normalizing crops in 2011. For metals, elevated inventories will start to weigh on prices. Only in the case of oil do we expect a tight market to continue pushing prices slightly higher in 2011 but gradually easing afterwards. This easing will be helped by a likely reduction in financial tensions in Europe, which should shift investment flows away from commodities into other assets with more contained risk premia. Nevertheless, risks are tilted to the upside, as strong demand, especially in Asia, will continue to support an upward trend in prices in the medium run.

The increase in commodity prices has been responsible, in part, for the increase in inflation observed in emerging economies at the end of 2010 (Chart 2). In particular, the increase in food prices has had a direct and important first-round effect on higher inflation in a number of countries–especially in Asia as discussed below–with the risk of feeding into overall inflation. However, going forward, the expected leveling of food prices will mean that this factor should become less important in determining headline inflation. Although the risk has also increased in developed countries, it is smaller than in emerging economies, given that food prices have a smaller weight on CPI and ample unused capacity and anchored inflation expectations will help keep inflation pressures in check.

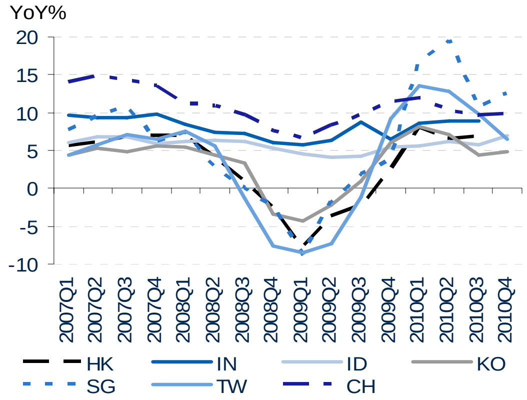
More worrying for emerging economies is the realization that rapid growth and strong capital inflows in Asia and Latin America are starting to generate overheating pressures, through inflation but also evident in rapid credit growth and rising asset prices. Indeed, we expect Asian economies to continue growing strongly, although in our opinion authorities should be able to steer them to a soft landing and avoid overheating, although that is surely a more pronounced risk than three months ago. Driven by domestic demand and high commodity prices, Latin America is also poised to grow strongly in 2011, converging to potential growth of around 4% in the region. As mentioned before, the biggest challenge for both regions will be to manage strong capital inflows. We expect policy to continue tightening in most countries, while at the same time imposing more administrative controls to limit those inflows and prudential measures to limit credit growth, especially in Asia.

2. Asia's remarkable rebound

While moderating from the peak momentum reached in the first half of 2010, Asia's economic rebound has continued at a robust pace in recent quarters. GDP outturns have continued surprising to the upside and, as noted above, the region has become an engine of recovery for the global economy, underpinned by especially strong growth in China and India. In the face of subpar growth in the industrialized world, this remarkable performance is due to increasing intraregional trade and robust domestic demand, both of which appear set to continue. With output gaps closed and inflation on the rise, risks are tilted to overheating. Accordingly, policymakers have increasingly shifted their focus from nurturing growth to maintaining price stability.

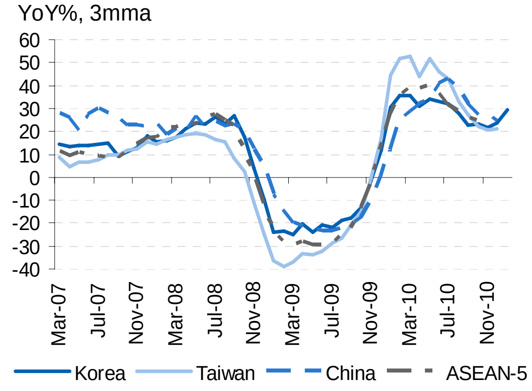
Asia's resilience—like that in other emerging markets—owes much to its strong underlying fundamentals, which include sound fiscal positions, low debt, high reserves, and well capitalized banking systems. Several Asian economies have earned upgrades from rating agencies over the past year. In the fourth quarter of 2010 and first month of 2011 alone, for example, China, Hong Kong, Indonesia, and the Philippines all received upgrades, while Thailand's outlook was upgraded.[1] There are exceptions, however, as Vietnam was recently downgraded on concerns about overheating and external pressures, and Japan was downgraded due to its high public debt ratio (around 200% of GDP).

Chart 5
GDP growth is moderating from the strong bounce-back in early 2010



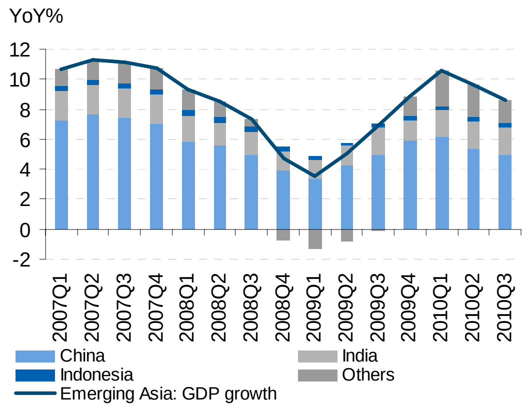
Source: CEIC and BBVA Research

Chart 6
Export trends are also moderating, but remain surprisingly strong



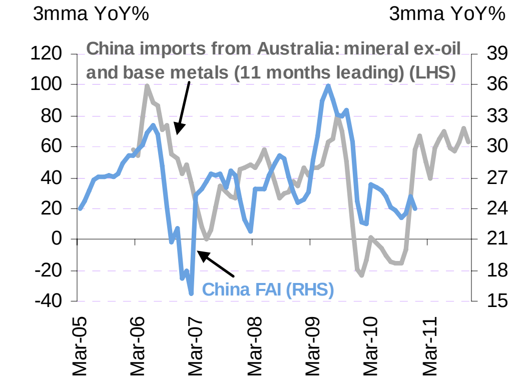
Source: CEIC and BBVA Research

Chart 7
Small and large economies alike propelled the region's growth in 2010



Source: CEIC and BBVA Research

Chart 8
Australia's commodity exports to China are correlated with China fixed investment



Source: CEIC and BBVA Research

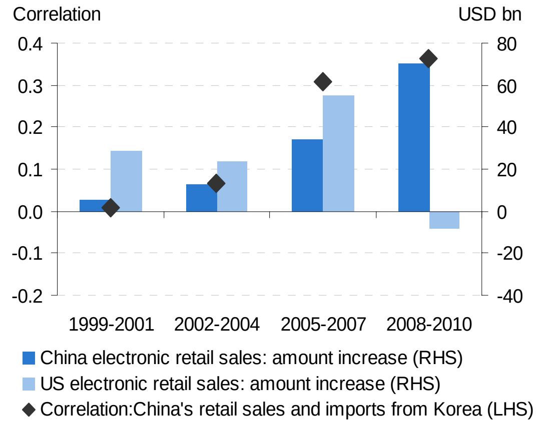
[1] China received upgrades from Moody's to Aa3 in November and S&P to AA- in December; Hong Kong received upgrades by Fitch, Moody's, and S&P, the latter to AAA; Indonesia received an upgrade from Moody's, joining Fitch at one notch below investment grade; and the Philippines received an upgrade by S&P to BB; Thailand's outlook was upgraded by S&P from negative to stable. Vietnam was downgraded by Moody's, which joined an earlier action by Fitch; Japan was downgraded by S&P to AA- this January.

Strong exports and resilient domestic demand have sustained the momentum

As expected, the region's growth pace moderated in the second half of 2010 following the unsustainably strong bounce-back of the first half (for Asia ex-China growth moderated from 7.2% y/y in H1 to 6.5% y/y in Q3, and for China from 11.1% y/y in H1 to 9.7% y/y in H2) (Charts 5 & 6). As flagged in our last Quarterly Asia Outlook, this was expected in view of the unwinding of the global inventory cycle and withdrawal of fiscal stimulus. That said, within the overall moderating trend, available data suggest that after a brief lull in Q3, momentum gathered pace again in Q4, with GDP growth in China, Indonesia, Philippines, Singapore and Taiwan all surprising to the upside and resulting in better-than-expected full-year growth outturns (Korea's Q4 GDP also surprised to the upside, although quarterly growth moderated. In contrast to 2009, when the region's smaller and more open economies contracted on the collapse of global trade, in 2010 regional growth was propelled by strong large and small economies alike (Chart 7).

Chart 9

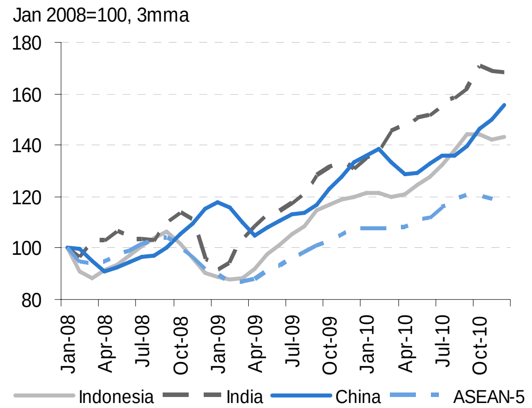
China's retail sales are an increasingly important driver of Korean exports



Source: CEIC and BBVA Research

Chart 10

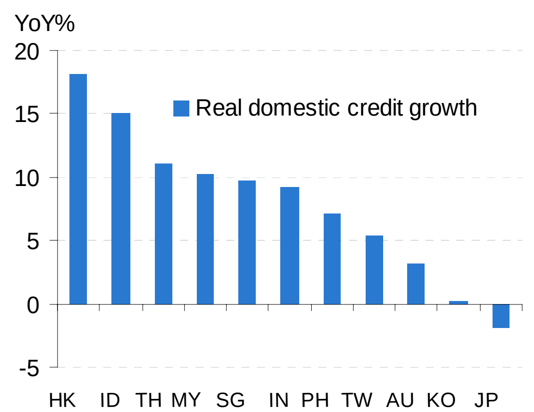
Retail sales* have been rising on strong job markets and consumer confidence



* Retail sales index in real terms
Source: CEIC and BBVA Research

Chart 11

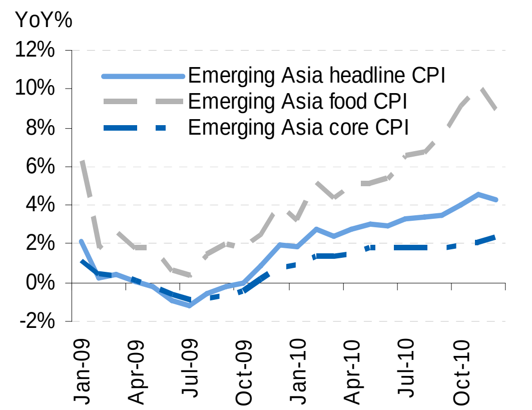
Rapid credit growth is supporting domestic demand



Note: 2010 December data for Australia, Japan, Hong Kong, Malaysia, Singapore, and Taiwan, and November data for India, Indonesia, Korea, Philippines, and Thailand
Source: CEIC and BBVA Research

Chart 12

Inflation has been driven by food prices, with spillovers to core



Source: CEIC and BBVA Research

How has Asia maintained such strong momentum even in the face of subpar growth in the industrialized world?

A key factor for Asia's growth resilience lies in robust demand from China. As has been well documented, government support for infrastructure projects, combined with lax liquidity and rising consumer demand, has generated a thirst in China for raw materials and final consumer and capital goods. The former has benefitted commodity-exporting economies such as Australia and Indonesia, while the latter has benefitted machinery- and electronics-exporting economies such as Korea, Philippines and Taiwan.

As China's import demand increases, its business cycle is becoming evermore important to the region. As illustrated in Chart 8, Australia's commodity exports to China, which have a growing share in Australia's total exports (16.7% in 2010, up from 6.9% in 2005), have a high correlation with China's fixed asset investment. And as illustrated in Chart 9, China's imports from Korea exhibit an increasing correlation with its domestic demand, suggesting that an increasing share of its purchases of Korean products are for final consumption as opposed to processing inputs (China is Korea's largest export destination, with a share of 25.1% in total exports for 2010). Thus, China's growth of electronics retail sales has been an important offset to weakening retail sales in the U.S.

Beyond China, resilient domestic demand in the region's two other large economies, India and Indonesia, have also been helping to bolster regional growth. For the first three quarters of 2010, India's GDP expanded by an impressive 8.8% y/y, underpinned by infrastructure-led investment. This has led to increased demand for raw material imports. For Indonesia, growth for the whole year 2010 registered a strong reading of 6.1%, thanks to rising consumer spending and fast credit growth (15.1% y/y real growth as of November 2010).

More generally, due to improved labor market conditions and stronger consumer sentiment, private consumption in many of the region's economies has picked up, with retail sales in Hong Kong and Korea, for example, coming out better than expected in 2010Q4 (Chart 10). Rising credit growth across the region has been further supporting private consumption, and especially increasing investment. In real terms, domestic credit growth in Hong Kong reached 18.1% y/y in December 2010, among the fastest in the region (Chart 11). In contrast, credit growth in Korea remains sluggish, as the economy is still undergoing deleveraging.

Rising inflation and asset price bubbles are the predominant concerns

Rising food and commodity prices have been creating inflationary pressures on the supply side, while the closure of output gaps and still-strong growth rates are increasingly generating pressures from the demand side. Core inflation rates generally remain low, but they are rising (Chart 12). Inflation has thus become the predominant policy concern in the region—overtaking worries about capital inflows for the time being—with central banks raising interest rates to stem inflationary expectations.

On the supply side, country-specific factors in the form of weather-related disruptions have played a major role. In addition, global increases in commodity and energy prices have also been factors on the supply side. In Australia, recent floods have driven up coal prices and disrupted supply channels, leading to somewhat higher inflation. Food price inflation has been especially severe in India (13.6% y/y in December 2010), China (9.6% y/y in December 2010), Indonesia (16.2% y/y in January 2011), and Korea (11.6% y/y in January 2011). India and Vietnam have been battling inflation for much of the past year, with inflation driven not only by rising food prices, but by overheating pressures as well. More recently, Indonesia has seen a significant pick-up in inflation, to 7.0% in January, well above the inflation target of 4-6%. Similarly, Korea has seen a rise in inflation to 4.1% in January, also above its inflation target of 2-4%.

It is noteworthy that food price inflation has not been seen everywhere across the region (Chart 13). For example, in Taiwan and the Philippines, food prices have been relatively stable, thanks to favorable weather conditions. In Singapore, where most food products are imported, currency appreciation has helped to keep a lid on inflation, while in Malaysia substantial subsidies on key staples have also help to keep food price inflation in check.

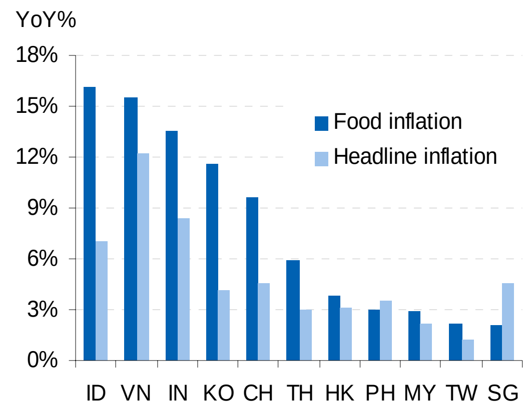
Besides supply-side factors, strong growth momentum and the closure of output gaps are generating demand pressures, through consumer expectations of future inflation or worker wage demands (Chart 14). In a few markets, such as Hong Kong and Singapore, rising housing costs are now leading to higher inflation, especially as rising rental rates are entering into the CPI with a lag. Demand-side pressures and the second-round effects of food and commodity price increases are increasingly being seen in rising core inflation, such as in Hong Kong, Korea, Malaysia and Thailand (Chart 15). In contrast, deflation persists in Japan.

In asset markets, risks of price bubbles continue on fast credit growth and capital inflows (Charts 16 & 17). To some extent, immediate concerns about asset price bubbles have receded with a recent moderation in capital inflows and following macro-prudential measures announced in some countries (see below). Nevertheless, the risk remains present, especially given prospects of renewed inflows during the remainder of 2011. Hong Kong's property sector remains especially exposed to price bubbles given the open capital account and linked exchange rate system to the USD.

Policymakers have stepped up measures to rein in inflation

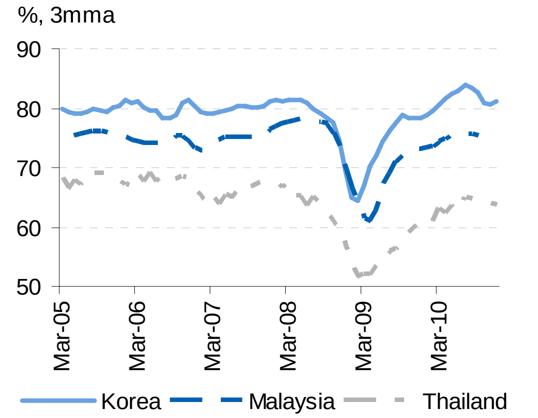
Asian policymakers have implemented a range of administrative measures to counter food price inflation, while on the whole such measures have been limited. The Korean authorities announced a package of anti-inflation measures in January, including freezes on college tuitions and utility charges, tariff cuts, strengthened monitoring of "pricing irregularities" to limit speculation, and measures to boost food supplies. Similarly, Thailand recently announced subsidies on fuel and palm oil imports, while Indonesia has reduced or eliminated tariffs on some essential food items, and Vietnam imposed price controls on key staples such as electricity and fertilizers. India is also reported to have banned exports of some staples to augment supplies in the local market.

Chart 13
Food price inflation is uneven reflecting country-specific factors



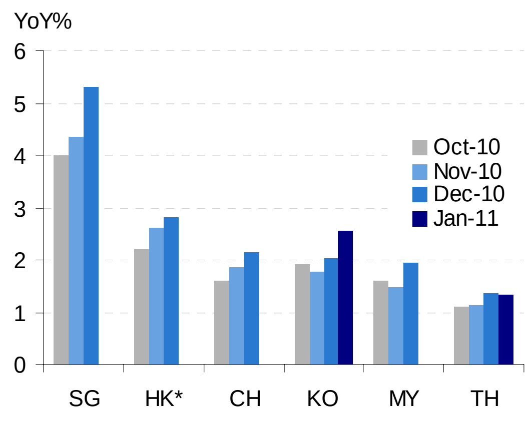
Source: CEIC and BBVA Research

Chart 14
Capacity utilization ratios are at or above historic norms



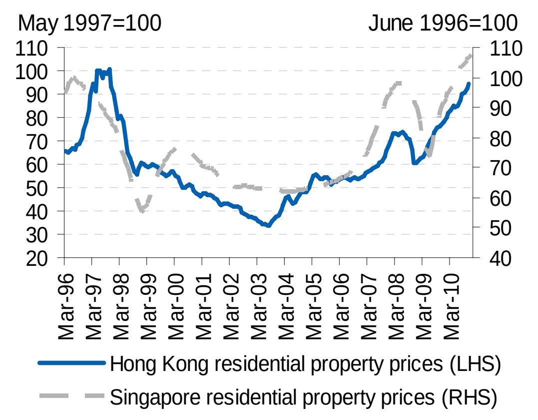
Source: CEIC and BBVA Research

Chart 15
Core inflation is picking up in some economies



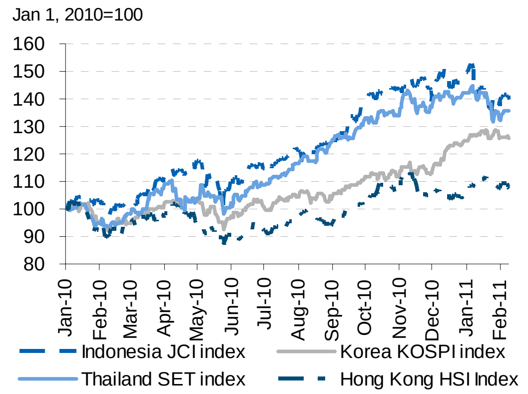
* excluding effect of Government One Off Relief Measure
Source: CEIC and BBVA Research

Chart 16
Property prices are accelerating in Hong Kong and Singapore



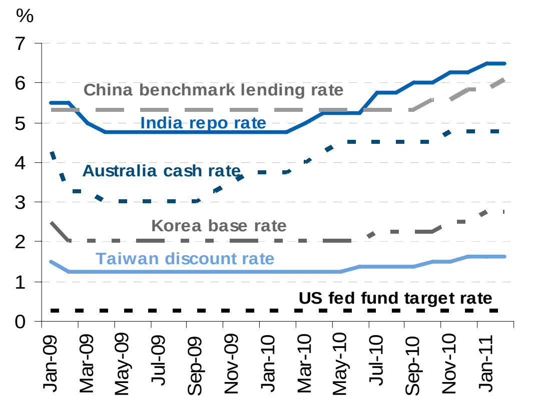
Source: CEIC and BBVA Research

Chart 17
Equity markets have been driven by capital inflows and growth prospects



Source: Bloomberg and BBVA Research

Chart 18
Asian central banks are raising interest rates to tame inflationary expectations



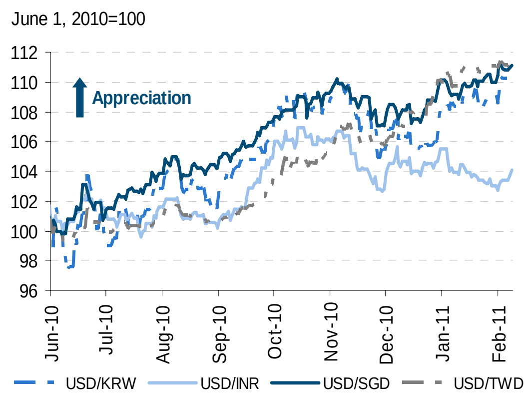
Source: CEIC and BBVA Research

Monetary policy tightening remains the most important ingredient of the policy response (Chart 18), although policymakers face a dilemma given prospects of capital inflows drawn in by higher interest rates. China and India have been the most aggressive in tightening monetary policy so far. In particular, China began to raise interest rates last October (three rate hikes so far), on top of a series of aggressive reserve requirement hikes; meanwhile, India has continued to raise interest rates, including its seventh hike in January. Korea, Thailand and Taiwan have also raised rates in the past few months, and Bank Indonesia made its first 25bp rate hike in early February to prevent temporary food inflation from translating into more persistent domestic factors. Philippines remains the only hold-out, as both headline and core inflation remain contained for the timing being, enabling the central bank to keep policy rates unchanged at a record low of 4% (for now).

Macro-prudential measures have become a favored instrument to limit capital inflows and prevent asset price bubbles

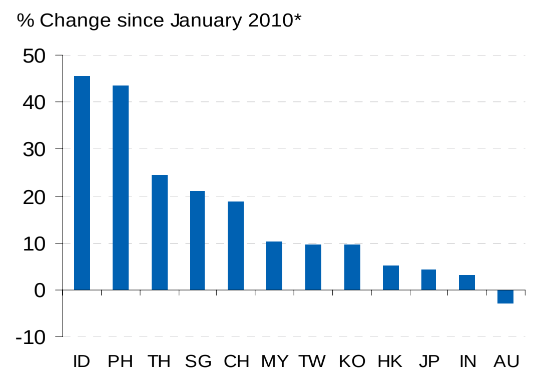
In response to capital inflows, policymakers have allowed some appreciation, while intervening to slow the pace (Charts 19 & 20). At the same time, macro-prudential measures have become a favored instrument to limit inflows and prevent asset price bubbles. The urgency of such measures has receded in the past few months as capital inflows have eased due to heightened risk aversion on European debt concerns and geopolitical tensions, as well as prospects of stronger recoveries in the US and core European zone (Chart 21 & 22). Nevertheless, policymakers remain weary of further inflows, which are likely to resume given prospects for further rate hikes in the region and strong growth prospects.

Chart 19
Currency appreciation pressures have temporarily eased



Source: Bloomberg and BBVA Research

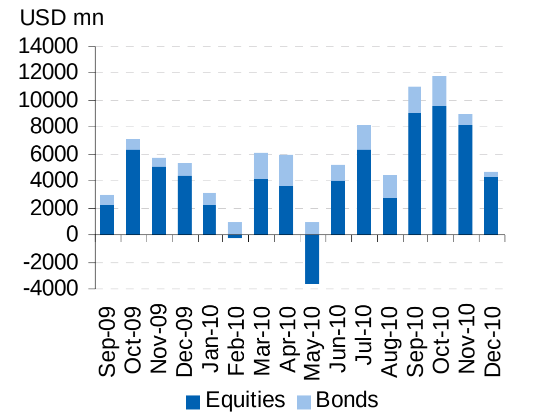
Chart 20
Foreign reserves have increased on intervention to slow appreciation



* Data available till Jan 2011 for Australia, Japan, Korea, Philippines and Singapore, till Nov 2010 for India, and till Dec for the rest countries.
Source: CEIC and BBVA Research

Chart 21

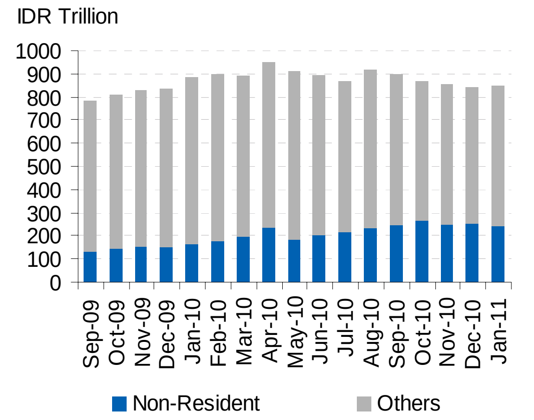
Net foreign portfolio inflows to Asia* have slowed in recent months…



* Includes China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Pakistan, Singapore, Sri-Lanka, Taiwan, Thailand, and Vietnam.
Source: EPFR Global and BBVA Research

Chart 22

…as evidenced by a leveling off of foreign bond holdings in Indonesia



Note: Holdings of government bonds and BI paper (SBIs)
Source: Bank of Indonesia and BBVA Research

The resort to macro-prudential measures, rather than outright capital controls reflects, in our view, is a desire among policymakers in the region to allow their domestic markets to remain integrated with global capital markets, while insulating their economies from volatile short-term capital inflows. In some cases, macro-prudential measures may also be viewed as a more appropriate and targeted response to asset price bubbles, for example in housing markets.

Korea, Indonesia, Thailand, and Taiwan have been especially active in implementing macro prudential measures to stem capital inflows—in some cases an intensification of existing regulations rather than new instruments—while China, Hong Kong, and Singapore have implemented such measures to slow credit growth and prevent housing price bubbles (Table 1). Among the most recent moves in this regard has been Korea where, in November and December, withholding taxes on foreign holdings of government bonds were announced, along with tighter scrutiny of foreign-currency derivatives positions and a new levy on banks' short-term foreign borrowing. Indonesia recently reintroduced a 30% of capital limit on banks' short-term overseas borrowing and raised reserve requirements on foreign currency deposits, while Taiwan tightened the ceiling on banks' non-deliverable foreign-exchange derivatives positions and increased reserve requirements on local-currency non-resident deposits.

In Hong Kong, the authorities implemented steps last November to cool the property market, including a 5-15% duty on short-term property sales. China and Singapore have both recently raised down payment requirements for second mortgages.

Table 1

Recent macro-prudential measures to reduce capital inflows (since last October)

Introducing or reinstating withholding taxes	• Thailand re-imposed a 15% withholding tax on foreign purchases of local government bonds (October 12, 2010). • Korea revived a 14% withholding tax on foreign holdings of government bonds (November 22, 2010).
Restricting banks' overseas borrowing	• Korea proposed to levies on banks' non-deposit foreign currency liabilities (December 19, 2010). • Indonesia capped banks' short-term foreign borrowing at 30% of banks' capital (December 30, 2010).
Curbing banks' holdings of foreign exchange derivatives	• Korea tightened restrictions on banks' holdings of foreign-exchange derivatives for domestic (50% of capital) and foreign banks (250% of capital) in June 2010. • Taiwan tightened the ceiling on banks' holdings of non-deliverable derivatives in TWD from 33% to 20% of their positions in the local currency (December 28, 2010).
Raising reserve requirements on foreign deposits	• Indonesia raised reserve requirements on foreign currency deposits from 1% to 5% effective March 2011, and to 8% effective June 2011 (December 30, 2010). • Taiwan imposed a 25% reserve requirement on local currency deposits of non-residents from December 30, 2010, and 90% on any net increase thereafter.
Restricting foreign fund investments in domestic portfolio markets	• Taiwan restricted offshore funds from investing more than 30% of their portfolios into money-market products and all types of local government debt with maturities less than one year (November 9, 2010).
Mitigating capital inflows to domestic property markets	• Hong Kong temporarily restricted immigration based on property investment (October 13, 2010). • China restricted the home purchase of foreigners, with at most one house for personal residence is allowed for foreigner working in China for more than a year (November 15th, 2010).
Encouraging capital outflows	• Thailand loosened limits on outward investments (September 23, 2010). • China allowed exporters to retain their foreign currency revenues in overseas accounts (December 31, 2010). • China permitted enterprises in relevant pilot regions to make direct overseas investments (excluding financial investments) in RMB (January 13, 2011).

Note: In addition to the above, Indonesia imposed a one-month holding period on Bank Indonesia Certificates (SBIs) in June 2010, and Taiwan banned international investors from placing funds in time deposits in November 2009.
Source: BBVA Research

3. Sustaining growth while managing inflation

Asian economies face two important tests in 2011. First is their ability to sustain growth in view of the uncertain outlook for external demand owing to fragilities in the major advanced economies. As noted above, we believe prospects are good given the strong growth momentum going into 2011, and robust domestic demand, particularly in the region's larger economies. The second test is their ability to manage this growth without succumbing to overheating, given rising inflationary pressures and prospects for renewed capital inflows. On this front, tighter monetary policy will be required, with the risk that central banks may have already gotten behind the curve or that they may fail to raise rates sufficiently on concerns about generating capital inflows.

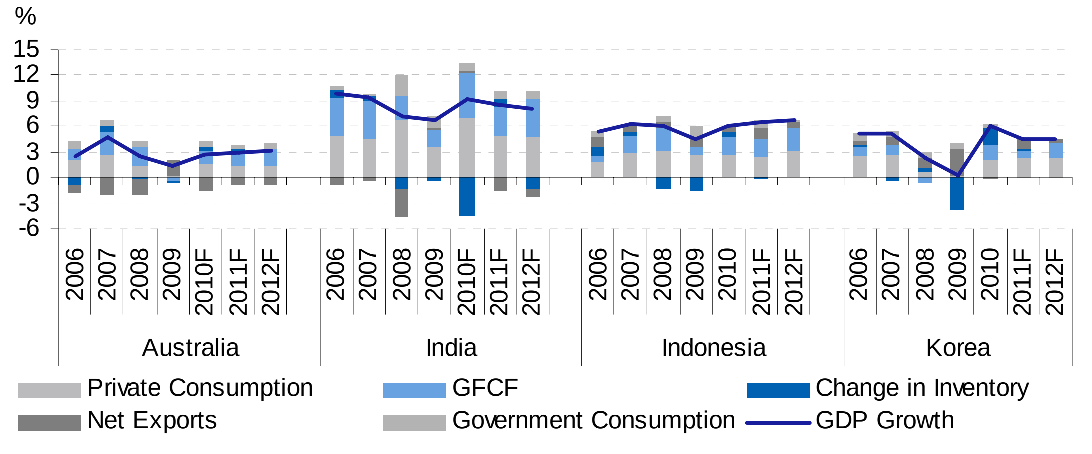
Our baseline scenario anticipates a healthy moderation in growth, with domestic demand becoming the main growth driver

We maintain our expectation of a resilient, albeit moderating growth outlook for Asian economies in 2011 (Asia ex-China: 4.8%; China: 9.2%). Growth rates for 2011 are expected to moderate in all economies, except for Indonesia and Vietnam, where we anticipate modest pickups toward medium-term potential growth (Table 2). Despite further monetary policy tightening, we expect strong growth to continue in China and India on robust domestic demand. We have cut back our projection for Australia to 3.0%, from 3.3% previously, on account of the recent devastating floods in Queensland which are anticipated to result in a modest lost in output. Although Japan is expected to realize a strong growth of 4.3% in 2010, we expect growth pace to moderate in line with our previous expectations, to 1.5% in 2011 on sluggish domestic demand, and lack of scope for offsets from public spending due to the need to reduce high public debt levels.

Following the strong bounce backs in 2010 for the region's smaller, more export-dependent economies, growth is expected to moderate in line with potential. We expect Hong Kong's growth, for example, to moderate from 6.5% in 2010 to 5.0% in 2011, as strong demand and spillovers from China sustain growth even as external demand moderates. In Korea, Taiwan, and Singapore, growth is also expected to trend back toward potential from extraordinary strong rebound on global trade turnaround last year. Generally, we expect the region's quarterly growth momentum to be lower in the first half of 2011, with a slight pick up in the second half as recoveries gather pace in the advanced economies (Asia ex-China: 4.6% y/y in H1 and 5.0% y/y in H2).

Domestic-led growth (Chart 23) should help to contribute to the global rebalancing process. In particular, strong domestic demand in China, India and Indonesia from rising private consumption and on-going infrastructure investment projects should help to reduce current account surplus where relevant (India is running a current account deficit).

Chart 23
Selected GDP projections: domestic demand-led growth



Source: CEIC and BBVA Research

Rising inflation is the key revision to our outlook

The most significant revisions to our outlook are to inflation, where we have increased our projections in a number of economies due to the influence of rising food and commodity prices and overheating pressures. That said, our baseline anticipates inflation to stay moderate, although we see upside risks to the outlook.

The most significant upward revisions for 2011 (period averages) are for China (from 3.3% previously to 4.5%), Hong Kong (from 4.0% to 5.2%), Indonesia (from 5.7% to 6.2%), Singapore (from 2.5% to 3.5%), and Korea (from 3.1% to 3.4%). Inflation is particularly worrisome in Vietnam, where a combination of surging food prices, currency depreciation, and overheating pressures have led to an acceleration; we have thus raised our 2011 inflation forecast for Vietnam from 8.5% previously to 9.9%. We have revised our outlook for Australia marginally higher in view of the disruptions to supply chains from the floods (2.9% to 3.0%). And finally, we expect inflation to remain high for India, at 6.8%, in line with our previous projections as the authorities continue tightening monetary policy to tame inflationary expectations (Table 3).

In spite of the pick up in inflation, we expect overall levels to remain modest. This is based on our global projections of steady or falling food and commodity prices, and a moderation in growth rates toward potential, which would limit overheating pressures. Furthermore, government efforts to improve supply and distribution of key staples should help, as should anticipated further monetary tightening and currency appreciation. On this basis, we expect inflation in most Asian economies to peak in mid-2011, and gradually ease thereafter.

Despite the sanguine outlook, we do see upside risks to the inflation outlook, particularly if food and commodity prices do not ease as expected. Also, risks of a delay in interest rate hikes because of worries about capital inflows could lead to higher inflation and asset bubbles.

Currency appreciation is expected to continue, at a slower pace

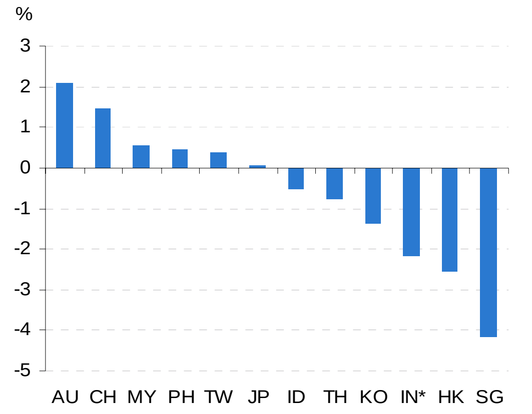
We expect most Asian currencies to remain under appreciation pressures in 2011, given widening interest differentials and resilient growth prospects, which should lead to further capital inflows. However, the pace of appreciation against the USD is likely to be modest, in view of our expectations of a strengthening tendency of the USD against other major currencies (especially against the EUR and JPY), as well as further resistance by central banks to allow significant appreciation–including through further foreign exchange intervention and macro-prudential measures to limit inflows. Further gradual appreciation of the RMB, by about 5% against the USD during the course of 2011, should also support the strengthening tendency of Asian currencies (Table 4).

The outlook for policies is further tightening

Policymakers now face the dilemma of having to tighten monetary policy to stave off overheating pressures, while managing capital inflows in an environment of low global interest rates. The dilemma has given rise to an eclectic set of policy instruments, with monetary tightening accompanied by further macro-prudential measures to slow credit growth and capital inflows, as well as administrative measures in some cases to help ease food prices.

Chart 24

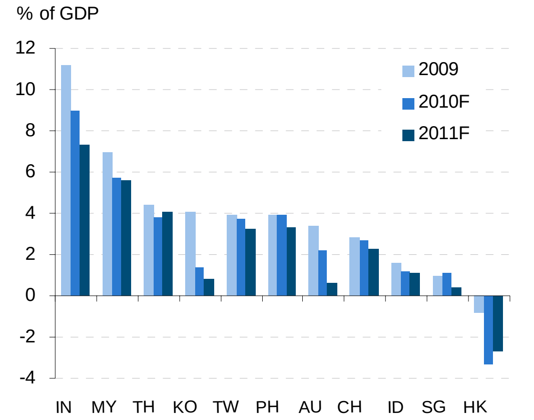
Real policy rates in many Asian countries remain negative



*Real policy rate of India is calculated using WPI
Source: CEIC and BBVA Research

Chart 25

Most emerging Asian economies are aiming at smaller deficits in 2011



Source: CEIC and BBVA Research

We see scope for more monetary tightening in 2011, which is likely to be front-loaded in view of current lax policy settings (Chart 24) and rising inflation. We anticipate four more 12.5bp hikes in Taiwan, three more 25bp hikes in Korea, and two more 25bp hikes in Australia, China, India, Indonesia, Malaysia, Philippines and Thailand this year (Table 5). In some cases, these are likely to be supplemented by additional quantitative measures to absorb liquidity, through hikes in reserve requirements and open market operations, especially in China and possibly in India and Indonesia as well.

Fiscal policy stimulus has already been withdrawn in most cases (Chart 25), with the exception of China where the authorities have signaled further fiscal support in 2011. In the near term, fiscal policy in much of the region is likely to be oriented toward mitigating the impact of rising food and commodity prices on low income segments of populations, although some countries, such as Indonesia, are expected to trim energy subsidies during the course of 2011 through electricity tariff or fuel price adjustments. While most Asian economies have sound fiscal positions, in a handful of countries with large deficits and/or debt levels, fiscal consolidation is a priority, particularly in India, Malaysia, and Japan.

4. Risks are tilted toward overheating

For much of 2010, risks in the region were balanced between the uncertain outlook for external demand on the one hand, and upside risks to growth and inflation on the other. With output gaps closed and inflation on the rise, risks are now tilted toward overheating. Strong domestic demand and improving prospects in the US make it more likely that Asian economies will be able to sustain strong growth in 2011. In view of this, the shift by policymakers from nurturing growth toward maintaining price stability is appropriate. Indeed, the main risk is that central banks will fail to tighten policy sufficiently or fast enough to offset rising inflationary pressures.

Prospects for renewed capital inflows exacerbate the upside risks. While such flows have diminished in the past few months, we anticipate a resumption of inflows during the course of the year. Policymakers are likely to continue responding with a mix of macro-prudential measures, and further currency appreciation to absorb inflows and avert risks of asset price bubbles, as well as further intervention to slow the pace of appreciation.

Although receding, downside risks to the outlook are still present from the fragilities in industrial country demand, especially in light of lingering risks from the European debt crisis, and geo-political risks on the Korean peninsula and more recently in the Middle East. Also, higher-than-expected inflation in China could give rise to a more pronounced tightening, with negative growth implications. The region’s smaller, export-dependent economies remain especially vulnerable to such downside risks. Rising food and commodity prices could also undermine consumer purchasing power and derail growth trajectories. Should such risks materialize, most Asian economies have room for further fiscal expansion and policies to mitigate the impact of rising costs on consumers.

Country-specific risks also bear watch. Thailand’s political tensions may continue in the run-up to general elections expected in mid-year. Risks of overheating are especially severe in Vietnam and in India. And Australia is still coping with the costs of reconstruction from the floods in Queensland.

5. Tables

Table 2

Macroeconomic Forecasts: Gross Domestic Product

(YoY% growth rate)	2008	2009	2010 (E)	2011 (F)	2012 (F)
U.S.	0.4	-2.6	2.8	3.0	2.7
EMU	0.3	-4.0	1.7	1.7	1.8
Asia-Pacific	5.6	3.7	8.1	6.5	6.4
Australia	2.1	1.2	2.8	3.0	3.2
Japan	-1.2	-6.3	4.3	1.5	1.5
China	9.6	9.2	10.3	9.2	9.0
Hong Kong	2.2	-2.8	6.5	5.0	4.5
India	7.3	6.8	9.1	8.5	8.0
Indonesia	6.0	4.5	6.1	6.4	6.7
Korea	2.3	0.2	6.1	4.5	4.5
Malaysia	4.7	-1.7	6.9	4.8	5.4
Philippines	3.7	1.1	7.3	4.5	4.3
Singapore	1.8	-1.3	14.7	5.0	4.8
Taiwan	0.7	-1.9	10.5	5.1	4.9
Thailand	2.5	-2.3	7.7	4.0	4.8
Vietnam	6.3	5.3	6.8	6.9	7.2
Asia ex China	2.9	0.1	6.7	4.8	4.7
World	3.0	-0.6	4.8	4.4	4.4

Source: CEIC and BBVA Research

Table 3

Macroeconomic Forecasts: Inflation (Avg.)

(YoY% growth rate)	2008	2009	2010	2011 (F)	2012 (F)
U.S.	3.8	-0.3	1.6	1.3	1.5
EMU	3.3	0.3	1.6	1.8	1.6
Asia-Pacific	5.7	0.3	3.5	3.8	3.5
Australia	4.4	1.8	2.9	3.0	2.6
Japan	1.4	-1.4	-0.7	-0.2	0.4
China	5.9	-0.7	3.3	4.5	4.0
Hong Kong	4.3	0.5	2.4	5.2	3.7
India	8.7	2.1	9.4	6.2	5.9
Indonesia	9.8	4.8	5.1	6.2	5.9
Korea	4.7	2.8	3.0	3.4	3.0
Malaysia	5.4	0.6	1.7	2.7	2.4
Philippines	9.3	3.2	3.8	4.0	4.0
Singapore	6.6	0.6	2.8	3.5	3.0
Taiwan	3.5	-0.9	1.0	1.7	1.5
Thailand	5.5	-0.8	3.3	3.4	3.0
Vietnam	23.1	7.1	9.2	9.9	8.2
Asia ex China	5.5	1.0	3.7	3.3	3.2
World	6.1	2.2	3.6	3.7	3.5

Source: CEIC and BBVA Research

Table 4

Macroeconomic Forecasts: Exchange Rates (End of period)

		2008	2009	2010	2011 (F)	2012 (F)
U.S.	EUR/USD	0.70	0.70	0.75	0.78	0.77
EMU	USD/EUR	1.50	1.40	1.34	1.29	1.30
Australia	USD/AUD	0.67	0.90	1.02	0.99	0.85
Japan	JPY/USD	96.1	92.1	81.1	95.0	112.0
China	CNY/USD	6.84	6.83	6.61	6.30	6.00
Hong Kong	HKD/USD	7.75	7.75	7.77	7.80	7.80
India	INR/USD	48.6	46.6	44.7	43.0	43.0
Indonesia	IDR/USD	10838	9395	8996	8800	9000
Korea	KRW/USD	1364	1166	1126	1000	988
Malaysia	MYR/USD	3.56	3.52	3.06	3.00	2.95
Philippines	PHP/USD	48.3	46.8	43.8	43.0	43.0
Singapore	SGD/USD	1.49	1.40	1.28	1.25	1.23
Taiwan	NTD/USD	33.0	32.3	29.3	28.2	27.8
Thailand	THB/USD	34.8	33.3	30.1	31.5	31.0
Vietnam	VND/USD	17433	18479	19498	21000	22000

Source: CEIC and BBVA Research

Table 5

Macroeconomic Forecasts: Policy Rates (End of period)

(%)	2008	2009	2010	2011 (F)	2012 (F)
U.S.	0.61	0.25	0.25	0.25	0.50
EMU	2.73	1.00	1.00	1.00	1.00
Australia	4.25	3.75	4.75	5.25	5.50
Japan	0.10	0.10	0.10	0.10	0.25
China	5.31	5.31	5.81	6.56	7.06
Hong Kong	0.50	0.50	0.50	0.50	0.75
India	6.50	4.75	6.25	7.00	7.50
Indonesia	9.25	6.50	6.50	7.25	6.50
Korea	3.00	2.00	2.50	3.50	4.00
Malaysia	3.25	2.00	2.75	3.25	3.50
Philippines	5.90	4.00	4.00	4.50	5.25
Singapore	1.00	0.69	0.48	0.45	0.70
Taiwan	2.00	1.25	1.63	2.13	2.63
Thailand	2.75	1.25	2.00	2.75	3.00
Vietnam	8.50	8.00	9.00	10.50	9.00

Source: CEIC and BBVA Research

DISCLAIMER

This document and the information, opinions, estimates and recommendations expressed herein, have been prepared by Banco Bilbao Vizcaya Argentaria, S.A. (hereinafter called "BBVA") to provide its customers with general information regarding the date of issue of the report and are subject to changes without prior notice. BBVA is not liable for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, or to undertake or divest investments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. The contents of this document are based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. BBVA accepts no liability of any type for any direct or indirect losses arising from the use of the document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, options and securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying stocks. Investors should also be aware that secondary markets for the said instruments may be limited or even not exist.

BBVA or any of its affiliates, as well as their respective executives and employees, may have a position in any of the securities or instruments referred to, directly or indirectly, in this document, or in any other related thereto; they may trade for their own account or for third-party account in those securities, provide consulting or other services to the issuer of the aforementioned securities or instruments or to companies related thereto or to their shareholders, executives or employees, or may have interests or perform transactions in those securities or instruments or related investments before or after the publication of this report, to the extent permitted by the applicable law.

BBVA or any of its affiliates´ salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

This document is provided in the United Kingdom solely to those persons to whom it may be addressed according to the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 and it is not to be directly or indirectly delivered to or distributed among any other type of persons or entities. In particular, this document is only aimed at and can be delivered to the following persons or entities (i) those outside the United Kingdom (ii) those with expertise regarding investments as mentioned under Section 19(5) of Order 2001, (iii) high net worth entities and any other person or entity under Section 49(1) of Order 2001 to whom the contents hereof can be legally revealed.

The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA and the rest of entities in the BBVA Group which are not members of the New York Stock Exchange or the National Association of Securities Dealers, Inc., are not subject to the rules of disclosure affecting such members.

"BBVA is subject to the BBVA Group Code of Conduct for Security Market Operations which, among other regulations, includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. The BBVA Group Code of Conduct for Security Market Operations is available for reference at the following web site: www.bbva.com / Corporate Governance".

This report has been produced by the Asia Unit of the Emerging Markets team

Chief Economist of Emerging Markets
Alicia Garcia-Herrero
alicia.garcia-herrero@bbva.com.hk

Chief Economist for Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

Jenny Zheng
jenny.zheng@bbva.com.hk

Fielding Chen
fielding.chen@bbva.com.hk

Ricard Torne
Ricard.torne@bbva.com.hk

Mainland China
Daxue Wang
daxue.wang@bbva.com.hk

Markets Analysis
Richard Li
richard.li@bbva.com.hk

BBVA Research

Group Chief Economist
Jorge Sicilia

Chief Economists & Chief Strategists:

Regulatory Affairs, Financial and Economic Scenarios:

Financial Scenarios
Sonsoles Castillo
s.castillo@grupobbva.com

Financial Systems
Ana Rubio
arubiog@grupobbva.com

Regulatory Affairs

Economic Scenarios

Spain and Europe:
Rafael Doménech
r.domenech@grupobbva.com

Spain
Miguel Cardoso
miguel.cardoso@grupobbva.com

Europe
Miguel Jiménez
mjimenezg@grupobbva.com

Emerging Markets:
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Cross-Country Emerging Markets Analysis
Daniel Navia
daniel.navia@grupobbva.com

Pensions
David Tuesta
david.tuesta@grupobbva.com

Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

South America
Joaquín Vial
jvial@bbva.cl

Argentina
Gloria Sorensen
gsorensen@bancofrances.com.ar

Chile
Alejandro Puente
apuente@grupobbva.cl

Colombia
Juana Téllez
juana.tellez@bbva.com.co

Peru
Hugo Perea
hperea@grupobbva.com.pe

Venezuela
Oswaldo López
oswaldo_lopez@provincial.com

Market & Client Strategy:
Antonio Pulido
ant.pulido@grupobbva.com

Equity and Credit
Ana Munera
ana.munera@grupobbva.com

Interest Rates, Currencies and Commodities
Luis Enrique Rodríguez
luisen.rodriguez@grupobbva.com

Asset Management
Henrik Lumholdt
henrik.lumholdt@grupobbva.com

United States and Mexico:

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Mexico
Adolfo Albo
a.albo@bbva.bancomer.com

Macro Analysis Mexico
Julián Cubero
juan.cubero@bbva.bancomer.com

Contact details

BBVA Research
43/F, Two International Finance Centre
8 Finance Street
Central, Hong Kong
Tel. +852-2582-3111
Fax. +852-2587-9717
research.emergingmarkets@bbva.com.hk

BBVA Research reports are available in English, Spanish and Chinese