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Economic Outlook

Asia

May 2011
Economic Analysis

- **Asia's strong growth momentum has continued into 2011 on the back of robust domestic and external demand.**
- **We expect a moderating trend going forward** due to headwinds from high oil prices and supply disruptions from Japan's earthquake, although prospects for sustained growth are still good.
- **Inflation is the predominant risk to the outlook.** Second-round effects from recent increases in food and energy prices are evident, with demand pressures now more acute.
- **Further monetary tightening will be needed to tame inflation.** If commodity prices stay high, there is room in most countries for fiscal measures to cushion the inflationary and growth impacts.
- **Risks remain tilted to overheating.** That said, headwinds to growth may act as a balancing factor.

Index

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Summary

Asia's economies have continued to turn in an impressive growth performance. After registering a strong rebound in 2010 (China: 10.3%; Asia ex-China: 6.5%), growth momentum has continued into 2011 propelled by robust domestic and external demand. First quarter GDP outturns met or exceed expectations. Although signs of a moderating trend are becoming evident, prospects for sustained growth during the remainder of the year are good.

Despite the favorable outlook, two challenges stand out: (i) headwinds from surging oil prices and the impact of Japan's earthquake; and (ii) rising inflationary pressures. Regarding the former, the impact should be minimal due to Asia's strong growth momentum, an expected easing of commodity prices, and the short-term nature of supply disruptions in Japan. Inflationary pressures are a larger source of concern, and to address them policy makers have sustained, and in some cases stepped up their monetary tightening measures.

Relative to our last Outlook of three months ago, our revised baseline incorporates modestly lower growth for 2011 as a whole, with higher inflation. We are adjusting down our 2011 GDP forecast for Asia ex-China to a still strong 4.3% (from 4.8% previously), to take into account the impact of higher oil prices and disruptions from Japan. We expect growth to slow in Q2 and to rebound during the remainder of the year. In China, we are raising our full-year 2011 growth projection to 9.4% (from 9.2% previously) on account of the faster-than-expected Q1 outturn.

We are raising our 2011 inflation forecasts for a number of economies, including China, India, the Philippines, Singapore, and Vietnam. We expect inflation to remain under control as commodity prices ease during the second half of 2011 under our baseline, as supply disruptions that caused food price increases diminish, and as the effects of monetary tightening work to keep inflation expectations in check. Nevertheless, risks to the inflation outlook are still to the upside.

In view of inflationary pressures, monetary tightening is continuing, and in some cases being stepped up. This is occurring despite headwinds to growth. We expect further interest rate hikes during the remainder of the year, mostly front-loaded. A resumption of capital inflows is leading to further currency appreciation, which policy makers are tolerating as a way to help contain inflation.

Overheating and rising inflation remain the predominant risks in our view. In this regard, further monetary tightening is appropriate. If oil and commodity prices fail to recede as in our baseline, most economies have room for additional fiscal measures to soften the impact on growth and inflation. The impact of the earthquake in Japan also remains a risk, but should be short-term as reconstruction spending gets underway and as supply chains gradually return to normal.

1. Global outlook: recovery, global shocks and vulnerabilities

Before turning to the Asia Outlook, we review the Global Outlook. Readers who wish to do so may go directly to Section 2 on Asia (page 6).

The global economy will continue growing strongly, but risks are tilted to the downside.

The global economy continues to grow at a robust pace, and is still expected to expand by 4.4% both in 2011 and 2012, supported primarily by emerging economies (Chart 1). However, the threat coming from high commodity prices (especially oil) increases the uncertainty and introduces a risk to growth and inflation in most regions, even to some of those that might benefit directly from high commodity export prices. At the same time, local risks identified in the previous issue of the Global Economic Outlook continue more or less unchanged. In particular, financial stress in Europe is likely to continue, especially for Greece, Portugal and Ireland. The political noise around proposals to finally start the process of fiscal consolidation in the US will only add to uncertainty in the markets, even as we think that some form of fiscal adjustment will take place in the end. Finally, overheating pressures in emerging markets continue, although going forward they will be more of a concern in South America, given tailwinds from commodity prices.

While high commodity prices pose risks they are unlikely to dent growth.

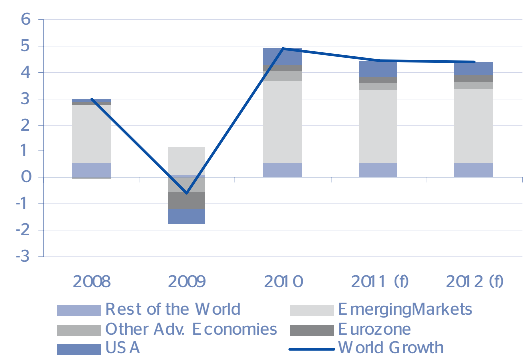
The greatest global risk stems from the rise in oil prices since the beginning of the year, caused mainly by political instability in the Middle East and North Africa (MENA). Although uncertainty is high and protests in the region are still unfolding, in our view, contagion to the point of disrupting oil production in other important oil producers beyond Libya will not occur. Thus, the geopolitical risk premia incorporated in oil prices will gradually be reduced, given ample OPEC spare capacity and OECD inventories, both above historical means. Nonetheless, oil prices may remain high at around US$110-120 per barrel during most of 2011, before receding gradually to around US$100 in 2012.

Given a rise in the price of other commodities such as food and metals as well, the main negatively affected regions will be the major developed countries and most of emerging Asia, the main importers of raw materials. On the other hand, the main beneficiaries of improved terms of trade would be the Middle East and Latin America, which will recycle part of this windfall revenue. However, a shock of this magnitude will be absorbed by the global economy without significantly affecting economic activity. This, together with relatively strong data in the first quarter of 2011, justifies relatively unchanged growth forecasts in most areas, as compared to our February Global Economic Outlook. The main exceptions are Mexico and South America, where strong data in the first quarter of 2011 and better terms of trade warrant a moderate upward revision of our growth forecasts for 2011. Core countries in Europe, as opposed to those in the periphery, will continue to grow, while risks to the U.S. forecasts shift from being biased upwards three months ago to be more balanced now because of higher oil prices.

High oil prices will push up headline inflation, necessitating earlier central bank interest rate increases in most regions.

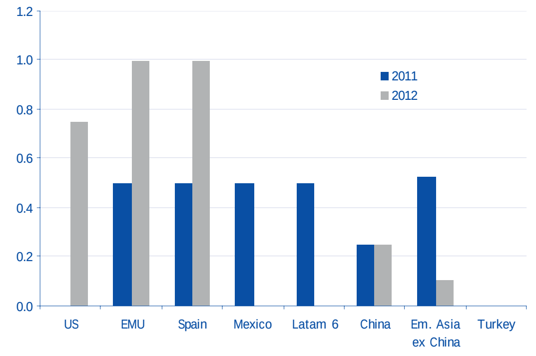
The main effect of the oil shock will be felt on prices. Higher inflation in most economies in 2011-12 will prompt monetary authorities to bring forward, and in some cases push for more aggressive, paths of interest rate increases (Chart 2). Nevertheless, there is still a wide heterogeneity in central bank approaches to the risks stemming from high oil and other commodity prices. In particular, in the US and euro zone, central banks are shifting—to varying degrees—their focus from supporting growth or preventing a tail risk scenario of very low growth and deflation, toward keeping inflation expectations well-anchored, particularly considering that the monetary policy stances are very accommodative. As a consequence, the balance of risks has tilted towards a higher probability of early hikes. The timing of the first hike depends on the perceived need to react to potential risks of second-round effects. The ECB's hawkish approach is to avoid any risk by being pre-emptive (and thus its first hike in April). On the other hand, the Fed, focusing more on the lack of sustainability in the recovery, prefers to wait and act only if risks materialize. Between these two approaches, emerging economies seem open to more front-loaded hikes if needed, but with an eye also on avoiding excessive capital inflows and exchange rate appreciation.

Chart 1
Global GDP growth and contributions



Source: BBVA Research and IMF

Chart 2
Changes in year-end expected official interest rates relative to February 2011



Source: BBVA Research

Financial tensions in the periphery of Europe will remain high.

As long as doubts persist about the solvency of countries in difficulty, namely Greece, Ireland, and Portugal, and risk of debt restructurings linger, headwinds to private sector funding to these economies and high sovereign spreads and could spread to other countries. Thus, a comprehensive and carefully designed approach to debt resolution—one that does not risk contagion to the rest of Europe—is urgently needed.

In the US, fiscal consolidation will likely be achieved.

In the U.S., the political process to reach a sustainable path for public debt involves difficult negotiations between two opposing approaches to deficit reduction. In the end, fiscal consolidation will have to come either from a reduction of entitlements or from higher tax revenues. In our opinion, both parties will reach an agreement that translates into lower deficits and a sustainable debt path, but the political process will be protracted.

Overheating concerns continue in emerging economies.

Emerging economies continue to show risks of overheating, but with marked heterogeneity. Some countries are beginning to confront these risks through more restrictive monetary policy, for example, in the important cases of China and Brazil. We think overheating risks are manageable but, going forward, they may become more pronounced in South America, to the extent that commodity price increases are a tailwind, but act as a headwind for emerging Asia. In addition, doubts about the extent of the slowdown in Japan could weigh on economic activity in most of Asia, given extensive trade links and integrated production chains. Furthermore, current account surpluses in much of Asia provide a buffer for the region, as compared to South America.

2. Asia's resilient growth story

Even by the standards of their fast-growing emerging market peers elsewhere in the world, Asia's economies have continued to turn in a remarkable growth performance. After registering a strong rebound in 2010 (China: 10.3%; Asia ex-China: 6.5%), strong growth momentum has continued into 2011 propelled by robust domestic and external demand. Although signs of a moderating trend are beginning to emerge, prospects for sustained growth during the remainder of the year are good, all the more so given clearer signs of recovery in the advanced economies.

That said, two concerns stand out. First, headwinds to growth have arisen from surging international oil prices and, more recently, from the economic impact of the tragic earthquake and tsunami in Japan. Second, inflationary pressures have intensified due to a combination of higher food and commodity prices and, more recently, demand pressures.

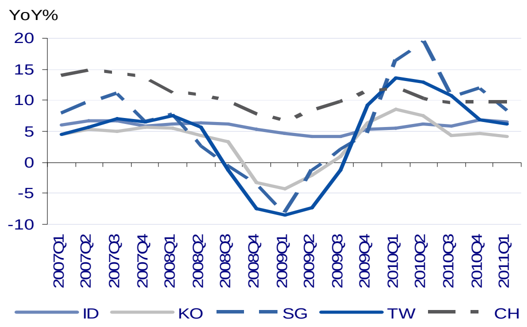
With respect to headwinds, we do not expect a significant dent to growth during the remainder of the year given the recent strength of growth momentum, expectations of an easing of commodity prices under our baseline, and the short-term nature or supply disruptions in Japan. Nevertheless, a moderating trend appears likely. As discussed in our previous *Asia Outlook*, such a slowdown would be a healthy development to avert further rises in inflation and overheating risks. In the meantime, to address inflationary risks, policy makers have sustained, and in some cases stepped up their monetary tightening measures, particularly in economies where demand-side pressures have become evident, such as in India. Further currency appreciation has also been permitted to help ease inflation.

Despite headwinds, growth remains strong

Activity indicators continue to point to strong growth momentum, with Q1 GDP in line with or exceeding expectations (Chart 3). In particular, Q1 GDP growth in China, Taiwan, and Singapore all surprised to the upside by considerable margins, while outturns in Korea and Indonesia were broadly in line with expectations, with sequential growth accelerating from the previous quarter.

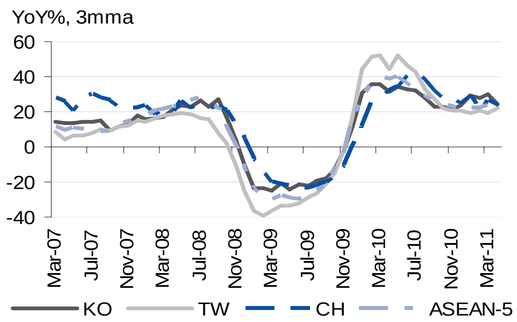
Underpinning the strong growth outturns has been surprisingly robust export performance (Chart 4), reflecting sustained intraregional trade from strong demand in China and India, as well as a rise in exports to advanced economies on demand for capital goods. Meanwhile, as fiscal stimulus is withdrawn, private domestic demand is holding up (Chart 5), facilitated by rapid credit growth (Chart 6) and strong income from low unemployment and rising wages (Chart 7 & 8). Credit growth has been especially fast in Hong Kong—an increasing source of concern to supervisory authorities about future asset quality—due to strong mortgage demand in the context of a surging property market, and loans to companies in Mainland China following a series of measures there to restrain domestic credit growth.

Chart 3
Growth momentum has been sustained into the first quarter of 2011



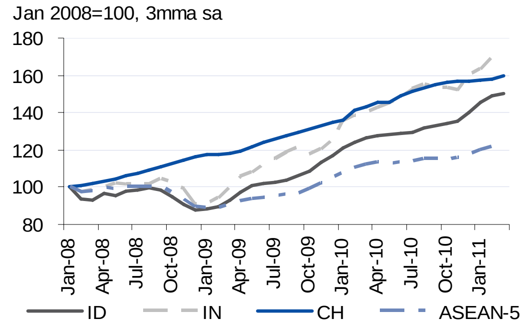
Source: CEIC and BBVA Research

Chart 4
Exports have held up



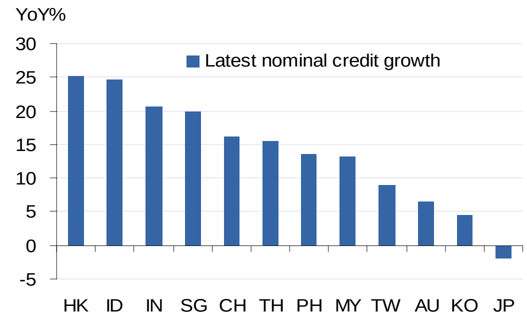
Source: CEIC and BBVA Research

Chart 5
Retail sales are strong, but moderating, as inflation weighs on purchasing power



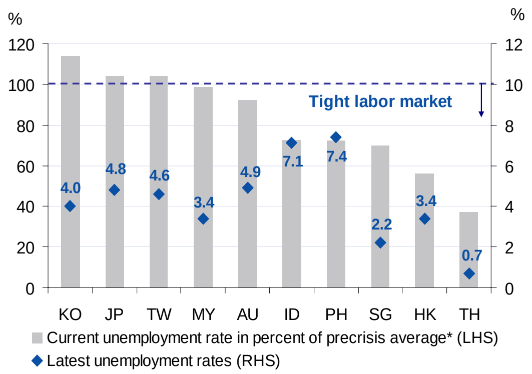
Source: CEIC and BBVA Research

Chart 6
Rapid credit growth is supporting domestic demand



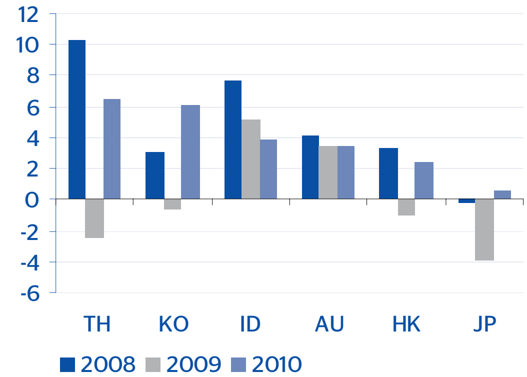
Source: CEIC and BBVA Research

Chart 7
Unemployment rates are below pre-crisis averages in most Asian economies



* Average unemployment rate in 2002-07
Source: CEIC and BBVA Research

Chart 8
Nominal wages are rising



Source: CEIC and BBVA Research

Although there are some signs of a slowdown

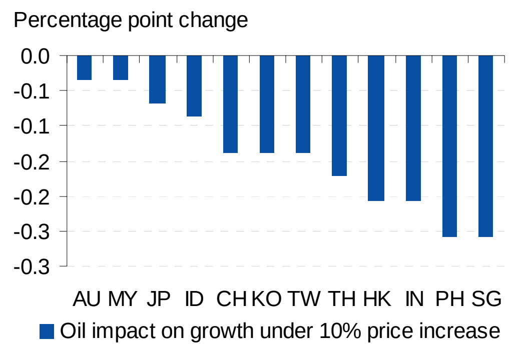
Notwithstanding the strong indicators, some signs of an incipient slowdown are evident. For example, PMI readings and industrial production for April in Australia, China, and Korea all declined. In India, where inflation remains stubbornly high and interest rates are being hiked at a more aggressive pace, capital goods production and investment spending are weakening. For its part, Japan has seen a plunge in activity indicators following the earthquake, with retail sales and industrial production down sharply, along with consumer and business confidence indicators (see Box on page 13).

Confronting headwinds to growth

As importers of raw materials, most Asian economies are vulnerable to surges in oil and other commodity prices (Chart 9 & 10). Indonesia, Malaysia, and Australia are the region's large commodity producers, but even they are vulnerable, to varying degrees, through the impact on domestic manufacturing and weaker external demand, as well as potentially adverse investor confidence effects from higher fuel subsidies (especially in Indonesia). That said, the impact so far has been minimal. In addition to strong growth momentum, fiscal measures to limit the pass-through of higher international prices to domestic markets have helped insulate economies (Table1). In addition, despite Asia's relatively high energy-intensive structure of production (especially in economies like Korea, Taiwan, and Thailand), oil accounts for only a portion of total energy usage, with natural gas and coal significant inputs as well; importantly, prices of the latter have not risen in tandem with oil (Charts 11 and 12).

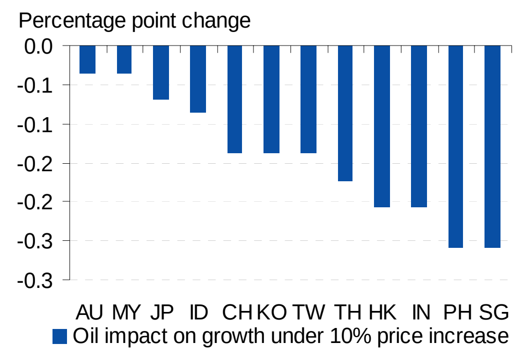
A second important headwind comes from disruptions from Japan's earthquake and tsunami, on both supply chains and on demand and growth in Japan (see Box on page 13). Thailand (auto industry) and Taiwan (semi-conductors and electronics) are especially vulnerable to supply disruptions given the large share of imported components from Japan. While a short-term impact is expected in Q2, to date disruptions have been manageable, perhaps due to inventories and producers' ability to find alternative suppliers. More generally, the impact on growth throughout the region is expected to be limited given the small share of Japan's imports in total trade. That said, given uncertainties about the outlook for Japan, especially in light of ongoing nuclear risks, the overall impact and effect on tourism and investment flows will need to be monitored.

Chart 9
GDP growth sensitivity to a hypothetical 10% rise in oil prices (including expected policy response)



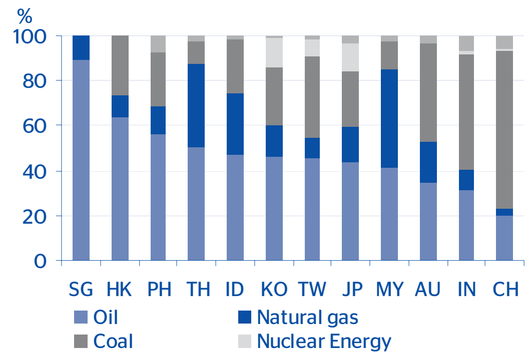
Source: BBVA Research

Chart 10
Inflation sensitivity to a hypothetical10% rise in oil prices (including expected policy response)



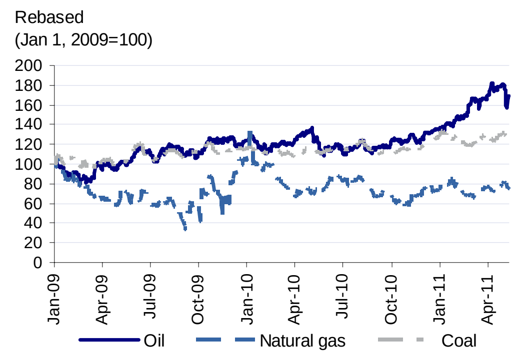
Source: BBVA Research

Chart 11
Uneven oil impacts on Asian economies given differing energy consumption patterns



Source: International Energy Agency and BBVA Research

Chart 12
Oil price increases have been larger than those of alternative energy sources



Source: Bloomberg and BBVA Research

Table 1
Measures in Asia to soften the impact of rising oil prices

	Recent actions	Previous measures
China	Upper limit for domestic oil price set at 130 USD/ barrel; implicit subsidies	The National Development Reform Council (NDRC) has pricing authority and can alter domestic prices whenever international crude oil prices fluctuate more than +/- 4%
Hong Kong	Electricity and transportation subsidies	Electricity subsidies
India	Fuel subsidies, direct cash subsidies to low income families for LPG & kerosene expected to be implemented by March 2012, possible delay of deregulation of diesel prices	The government controls the prices of oil products, and subsidizes oil companies, via three channels: (1) direct subsidy to oil companies; (2) "oil bonds"; (3) oil tax cuts
Indonesia	A plan to reduce subsidies by excluding private cars from using subsidized fuel has been put on hold	An unprecedented cash transfer program to 19 million poor families was implemented in 2005 to mitigate impact of fuel price increases. A similar cash transfer accompanied the fuel price increases in 2008.
Korea	Considering to lower crude oil import tariffs	Hand out US$10.2 billion to its lowest-income citizens to offset skyrocketing prices of oil in 2008
Malaysia	The government estimated to spend additional RM4 billion on fuel subsidies this year, and has no plan to cut the current subsidy rationalization program despite higher fuel prices.	Oil subsidies have been the traditional practice to 1) support low income fishermen and farmers; 2) provide relief on diesel prices for manufacturers and the transport industry
Philippines	Up to 500 million pesos (S$15 million) to subsidize fuel costs of small transport operators	1-2 pesos per liter subsidy for public utility vehicles directly provided by oil companies
Taiwan	(1) The government and the public will share 1/3 each for the oil price burden when international crude price reach US$120 a barrel. (2) Subsidies to farmers and fishermen whose livelihoods depend on the use of oil products. (3) Commodity tax cut by half; (4) Subsidies to transportation are under consideration	In 2007-2008, the government provided 12.5 billion Taiwan dollars in subsidies for certain sectors after fuel price hikes, such as for taxi drivers and mass transport companies.
Thailand	In December 2010, the Thai government announced to reintroduce diesel subsidies to make sure that the retail price of diesel was capped below THB30 (USD1) until April 2011 (with the recent extension).	The price cap on diesel was introduced briefly between March-July 2008 to alleviate the impact of the spike in global oil prices on producers and consumers.

Source: BBVA Research, government sources, and media reports.

Rising inflation and overheating risks continue to challenge policy makers

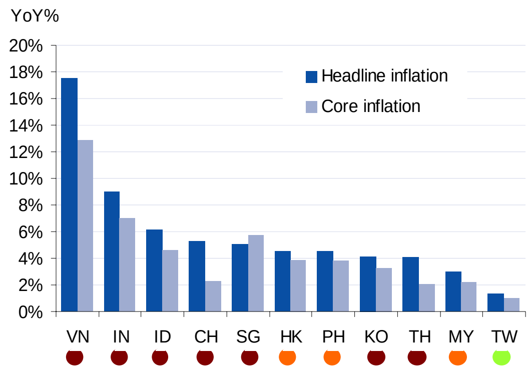
Inflationary pressures across Asia have been building since last October, with inflation exceeding targets or comfort levels in a number of economies, particularly in India, China, and Vietnam (Chart 13). Initially, the drivers of inflation were on the supply side, especially from rising food and energy prices. More recently, however, price pressures have spilled over to measures of core inflation, pointing to second-round effects as inflation expectations increase and demand side factors become an important contributor. Price pressures are evident not only in goods markets, but in asset markets as well, particularly in property sectors in China, Hong Kong, Singapore, and Taiwan.

Food and energy prices have shown some moderation in recent weeks, but are nevertheless important contributors to year-on-year inflation rates in a number of economies. The impact has varied, depending on both the magnitude of price increases and the individual country weights of food and inflation in consumer price, with Vietnam, India, Indonesia, and Korea most severely affected (Chart 14).

Inflation in Vietnam is especially high, with the CPI rising by 17.5% y/y in April, with pressures from higher global commodity prices exacerbated by overheating pressures and a series of recent currency devaluations. India has also been battling high inflation, at 9.0% y/y in March (WPI), well above the authorities' projection of 6.0%, as demand side pressures have raised questions about India's ability to grow above 8% without generating inflation, in view of infrastructure and other supply constraints.

In Indonesia and Korea, despite some easing of pressures in April, there are signs that inflation pressures have spilled over to the domestic side. More generally, output gaps across Asia have been closed, as seen in high capacity utilization rates (Chart 15) and tight labor market conditions (Chart 7 above), with unemployment rates in a number of economies significantly below historical norms. As a result, nominal wage rates are again rising after a decline during the global crisis in 2009 (Chart 8 above). In Hong Kong, a new minimum wage law took effect on May 1, which may result in a modest increase in overall wage rates and inflation. Meanwhile, the second-round effects of higher food and oil prices have also pushed up inflation expectations. In addition, in economies like Hong Kong and Singapore, rising housing rents associated with buoyant property markets are feeding into the CPI, as expected, after the usual lags. As a result, core inflation is trending up in Hong Kong, India, Indonesia, Korea, Thailand and Vietnam (Chart 16).

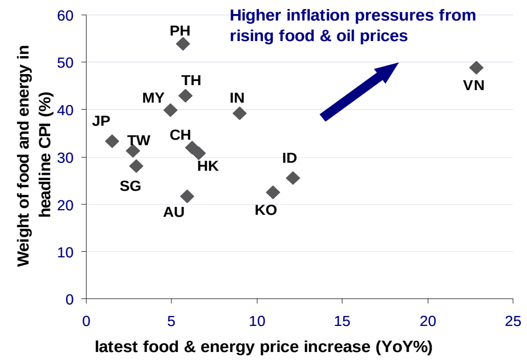
Chart 13
Inflation in many Asian economies has exceeded official targets



Note: Countries with inflation exceeding government's target or at historically high are marked in red, and countries with inflation in the upper half of the target range or above historically moderate levels are marked in yellow.

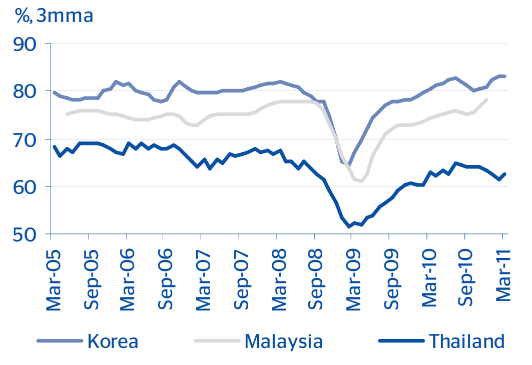
Source: CEIC and BBVA Research

Chart 14
Surging food and oil prices have been the major inflation drivers, with differing individual impacts



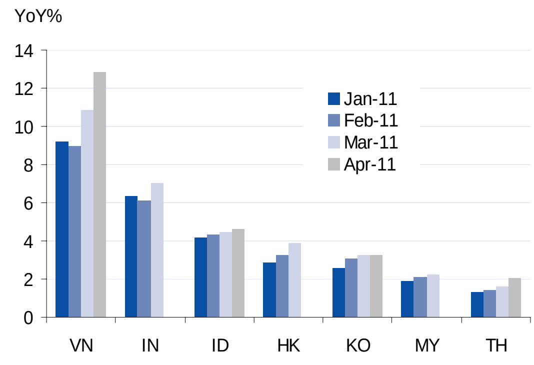
Source: CEIC and BBVA Research

Chart 15
Capacity utilization ratios are back to historical norms



Source: CEIC and BBVA Research

Chart 16
Core inflation is trending up

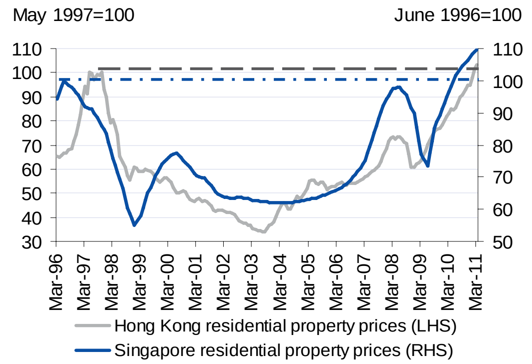


Source: CEIC and BBVA Research

At the other extreme of the spectrum, inflation remains quite low in Japan and Taiwan. In Japan, where deflation has been a persistent problem, pressures from the recent earthquake and associated supply disruptions may actually result in an increase in prices and an early end to deflation. Outside of Japan, Taiwan continues to record the region's lowest inflation rates (1.4% y/y in March), due to relatively low food price inflation on ample domestic supplies, and well-anchored inflation expectations.

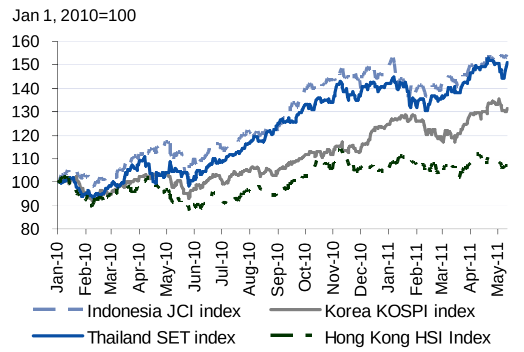
Risks of asset price bubbles remain a concern in property sectors, particularly in China, Hong Kong, Singapore, and Taiwan. Property prices in Hong Kong and Singapore have reached new historic highs (Chart 17), fed by low interest rates and rapid mortgage lending. In equity markets, share prices have recently declined due to fears of monetary tightening and bouts of global risk aversion (Chart 18), but they remain subject to upward trends, especially given the likelihood of further capital inflows.

Chart 17
Housing prices in Hong Kong and Singapore are reaching new highs



Source: CEIC and BBVA Research

Chart 18
Asian stock markets have performed well on strong growth prospects and capital inflows



Source: Bloomberg and BBVA Research

Central banks step up their efforts to tame inflation

In view of rising inflation and overheating risks, central banks have resumed, and in some cases stepped up the pace of monetary tightening (Chart 19). With inflation having surprised to the upside, and markets perceiving central banks to have gotten behind the curve, policy makers are effectively playing catch-up by front-loading their interest rate increases, despite expected headwinds to growth during the remainder of the year.

India has been the most aggressive in this regard, with a cumulative 100bp in rate hikes since the beginning of this year, most recently in early May with a 50bp hike, marking a shift away from the Reserve Bank of India's (RBI) previous gradual approach. China's central bank has also been aggressive, with 50bp hikes so far in 2011, accompanied by monthly reserve requirement hikes. Central banks in Korea, the Philippines, and Thailand have all hiked by 50bp so far this year, with 25bp hikes in Indonesia and Malaysia. In Singapore, where the exchange rate is used as the monetary instrument, a re-centering (appreciation) of the exchange rate band was announced in April as expected, marking the third consecutive tightening move since April 2010. Currency appreciation has also been permitted as a tool to control inflation in recent months, particularly in Indonesia and Korea.

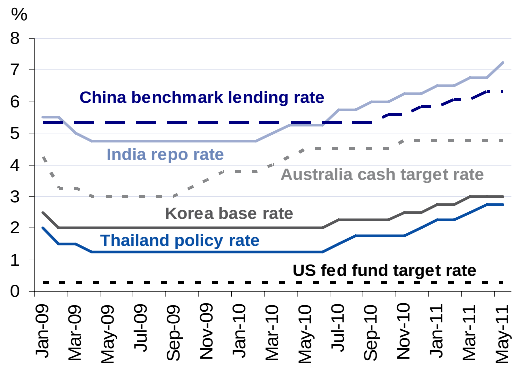
Within the region, Japan's central bank, appropriately, has been the outlier by maintaining a very lax monetary stance. Even before the earthquake, its economic recovery was fragile. Accordingly, the Bank of Japan (BoJ) has maintained interest rates at 0-0.1% and, since the earthquake, has injected liquidity into domestic financial markets, expanded its asset-purchase program, and has implemented a credit facility for banks to lend to businesses in the earthquake-affected region. The BoJ is also signaling the possibility of further exchange market intervention—following the G7's concerted action just after the earthquake—in light of appreciation pressures on the yen.

Renewed capital inflows and currency appreciation pressures

Capital inflows have moderated in recent months, but are again resuming given widening interest differentials and the region's strong growth prospects (Chart 20). Such inflows are continuing to put upward pressure on currencies (Chart 21). Monetary authorities continue to intervene, although the pace has slowed compared to last year (Chart 22).

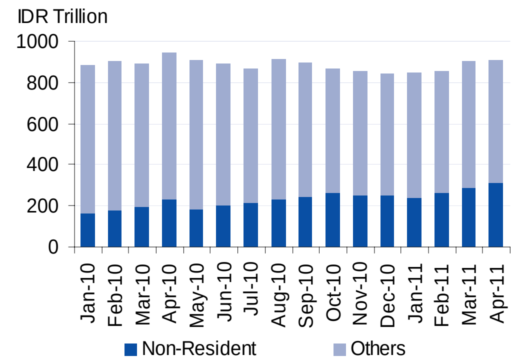
Country authorities have generally refrained from introducing new macro-prudential measures, a favored tool last year to counter capital inflows. This reflects, in our view, the recent moderating trend of inflows—together with the US Fed's indication of ending QE2—and a wait-and-see approach to evaluate the impact of measures already put into place. As noted in our last *Asia Outlook*, we believe that regional policy makers are inclined to keep their domestic markets integrated with global capital markets, and we do not expect to see draconian measures to limit inflows, although we would not rule out an intensification of enforcement of existing rules from time to time.

Chart 19
More interest rate hikes are expected to curb inflation expectations



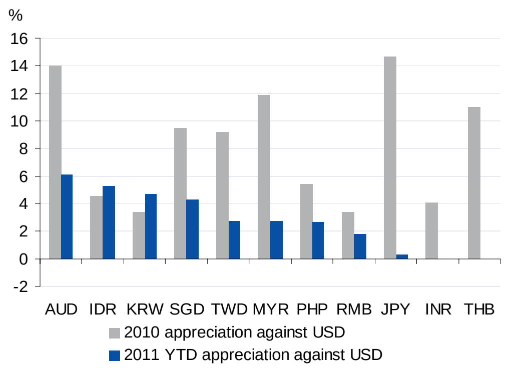
Source: CEIC and BBVA Research

Chart 20
Portfolio inflows to have resumed after a lull, as seen by foreign holdings in Indonesia's bond market



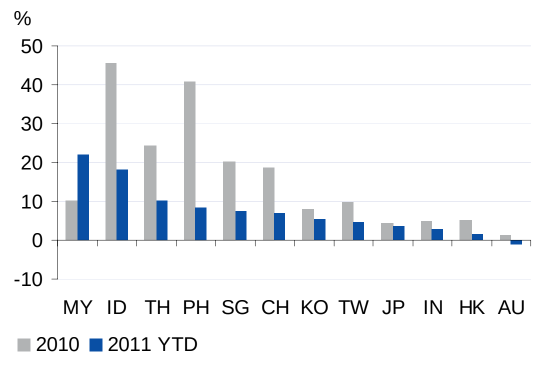
Note: Holdings of government bonds and BI paper (SBIs)
Source: Bank of Indonesia and BBVA Research

Chart 21
Currency appreciation against the USD is being permitted to counter inflation...



Source: Bloomberg and BBVA Research

Chart 22
...as suggested by slower foreign reserve accumulation from FX intervention



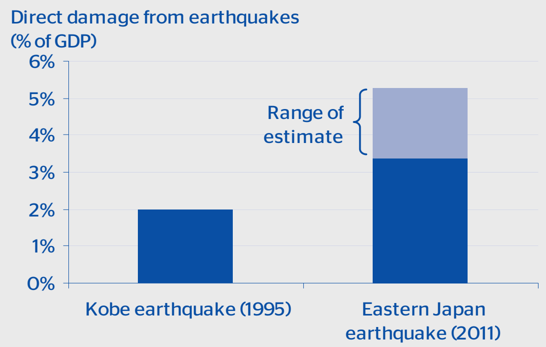
Source: CEIC and BBVA Research

Box: Japan's earthquake—deep short-term impact with uncertainties ahead

On March 11, 2011 a magnitude 9 earthquake struck Japan, with a subsequent tsunami and nuclear crisis. The earthquake devastated the Tohoku region of Northeast Japan. These events turned out to be the worst natural disaster in Japan since at least the 1995 Kobe earthquake. Although figures are still provisional, the Japanese government estimates the human toll (including dead and missing) to be above 25,000. At the time of this writing, the Japanese authorities were still struggling to bring the situation at the Fukushima nuclear plant under control and the consequences of further nuclear fallout were far from being known.

It is possible to analyze the economic consequences of this catastrophe from several perspectives. The most straightforward is to calculate the direct economic impact (property damage) of the earthquake. The affected region accounts for a relatively small share of national production – around 7% of Japan's GDP. The area most severely impacted by the earthquake and tsunami is a key agricultural region. It is also an important auto production center with significant raw material industries such as oil, steel, and pulp, as well as home to a number of nuclear power plants. The earthquake has damaged local infrastructure and caused many knock-on effects on the rest of the country. In addition to local infrastructure such as ports, airports, and roads, the earthquake has damaged homes, factories, and equipment. The Japanese government estimates this direct impact to be between ¥16-25 trillion, or between 3.3% and 5.2% of GDP, well above the damage caused by the Kobe earthquake of about 2% of GDP (Chart 23).

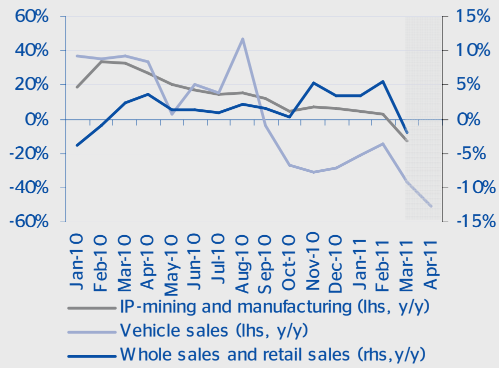
Chart 23
Estimate of the direct impact of earthquake in Japan



Source: BBVA Research based on Japanese government data

In addition to the direct economic impact, it is important to calculate the indirect effect which relates to production and growth. Industrial production has fallen sharply since the earthquake as a result of the closure of businesses and shops, disruptions to transportation and supply networks, and key services like power and communications (Chart 24). Over the last few weeks, there have been factory shutdowns in key industries, particularly in the automobile and electronics sectors which account for a large share of Japanese manufacturing. At the same time, power blackouts are expected to have significant impact on a wider range of industries. Furthermore, nuclear fears have undermined exports and tourism, and business sentiment as well. Indeed, as events have unfolded in recent weeks, estimates of the impact on supply chains and economic growth have increased.

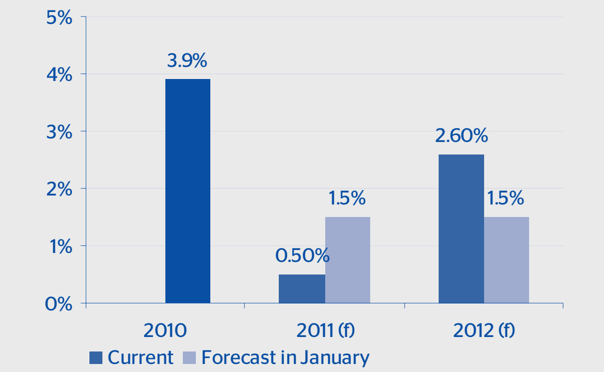
Chart 24
Post-quake activity indicators in Japan have plunged



Source: Haver Analytics and BBVA Research

Obviously, the situation described above is likely to have adverse impacts on growth in the near term. At the time of the earthquake Japan's economic recovery was on track, although it remained fragile. In 2010, GDP growth bounced back to 3.9% from a -6.3% decline in 2009. Indicators before the earthquake pointed to a return of growth to its potential at around 1.5%, which was not all that high due to weak domestic demand, and aging population, and other structural factors. The recovery was unfortunately disrupted by the quake. Estimates of the economic impact of natural disasters on economic growth are always imprecise. That said, growth in 2011 could be expected to be dragged down significantly. On the other hand, slowdowns in the aftermath of these kinds of events are usually followed by strong rebounds as consumers resume spending (especially replacing damaged durable goods) and as public reconstruction spending boosts activity. In the case of 2011 earthquake, the negative impacts on growth are likely to be concentrated in Q1 and Q2, followed by a sharp rebound in the following quarters. In sum, in the near term we forecast Japan's real GDP growth to be 1 pp lower, but for 2012 growth it is likely to be higher than our previous estimate (Chart 25).

Chart 25
Japan's GDP growth forecast (%)



Source: Haver Analytics and BBVA Research

The quake is estimated to be the most costly natural disaster in Japan's history, in part due to the potential lasting effects of radiation from the Fukushima nuclear plant. In fact, there is a great deal of uncertainty surrounding these figures and the risk is clearly tilted to a worsening of the situation. Meanwhile, power blackouts also add to uncertainty about the effects on economic activity. Therefore, the final impact of the quake could be higher than current estimates. Nonetheless, the impact should still be only limited to the near-term growth outlook.

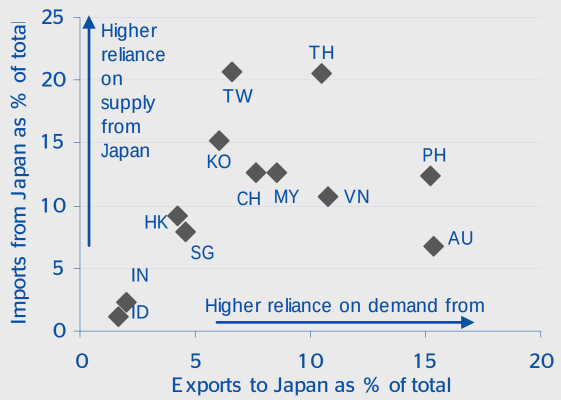
Will the disaster lead to an early end to deflation?

Before the earthquake, deflation was expected to last until mid-2012. Japanese deflation is a result of weak domestic demand on one hand and abundant production capacity on the other hand. The ensuing reduction in supply after the quake is pushing inflation upward, even more so given that the affected area is an important food producer. However, the impact on inflation should be only limited, offset by the downward pressure on prices from decreasing demand affected by weakened confidence. Therefore, we expect deflation to end toward the end of 2011, earlier than pre-quake forecast of mid-2012.

Will global economic growth be affected?

Japan is the third largest economy in the world. However, it is unlikely that any Japanese demand slump would seriously affect the pace of the global recovery. In fact, some countries may see an increase in exports to Japan as the reconstruction takes place. However, there may be adverse effects from the disruption to supply chains. Indeed, disruptions to global supply chains from Japan, especially for auto parts, have already affected regional economies in Asia and Europe. As can be seen in Chart 26, several Asian countries are highly exposed to trade with Japan, particularly Taiwan and Thailand. However, the supply chain disruptions should be temporary as factories recover their production in coming months.

Chart 26
Asian countries' trade with Japan



Source: CEIC and BBVA Research

Is there enough fiscal room to support reconstruction? How will exchange and interest rates be affected?

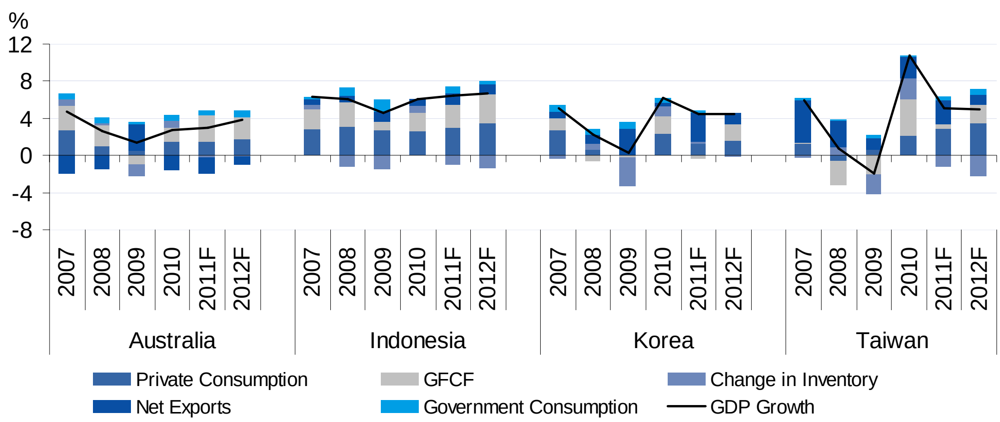
Japan's weak fiscal position is clearly a downside risk to the conventional V-shaped recovery after a natural disaster. The reconstruction effort comes at a time when fiscal space is already constrained with public debt at around 200% of GDP, prompting recent downgrades of the sovereign credit outlook by rating agencies.

Clearly, extra budgetary spending for relief work and post-quake reconstruction has undermined the government's efforts to tackle the deficit. Japan has passed the first supplementary budget of ¥ 4 trillion (0.5% of GDP). The extra budget is based on a reallocation of spending from other uses and should not increase either the deficit or the bond issuance. However, further extra budget spending will no doubt incur new debt issuance. It is possible that the reconstruction spending will be partially financed by increasing the rate of the sales tax, which could undermine the strength of the recovery. At the time of this writing, no tax measures had been passed, although the government had already acknowledged, even before the earthquake, that a 3% increase in tax on consumption was under consideration. Regarding interest rates, the likely worsening in the fiscal position should exert some upward pressure on long-term rates. However, since most of the public debt is held domestically, this effect should be small and manageable. In the short term, the Bank of Japan is expected to keep policy rates at the current level of 0-0.1%. On the exchange rate front, the Bank of Japan, together with the G7, intervened in the foreign exchange rate market at the outset of the crisis, resisting the appreciation pressure due to repatriation capital inflows after the quake.

3. A robust outlook, despite headwinds

As noted above, Asian economies face two challenges in the period ahead. One is to sustain growth in the face of expected headwinds from rising oil and commodity prices and the fallout from Japan's earthquake; the other is to tame rising inflation. To some extent, these challenges are offsetting, as headwinds to growth and a moderation in the pace of activity should help to avert risks of overheating. We believe that prospects for sustained growth during the remainder of the year are good (Chart 27), although we do expect to see a moderation in activity indicators in the coming months.

Chart 27
Domestic demand is expected to propel the region's economies in 2011-12



Source: CEIC and BBVA Research

Our baseline anticipates a moderation in growth, with higher inflation

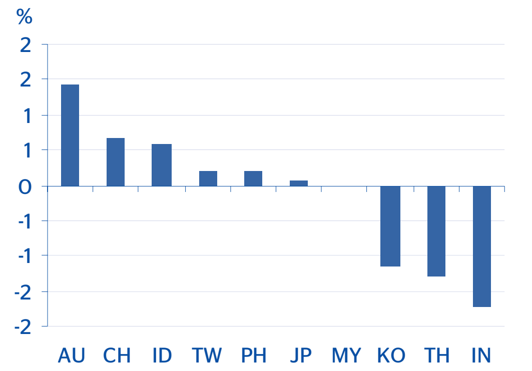
Looking ahead, we expect the headwinds from higher oil prices and disruptions from Japan's earthquake to begin showing up in Q2 data. Given the better-than-expected Q1 GDP outturns and our baseline projections of easing commodity prices, however, our full-year growth forecasts are only slightly lower than our previous *Asia Outlook* of three months ago. On the other hand, we have raised our regional inflation forecasts in light of recent trends.

We anticipate further modest monetary tightening in the coming 1-2 quarters. Our projections of interest rate increases would be even larger—real interest rates remain negative in many Asian economies (Chart 28)—were it not for the headwinds to growth, of which policymakers are no doubt aware. On the fiscal front, our projections continue to incorporate smaller deficits in 2011 (Chart 29).

We are adjusting down our 2011 GDP forecast for Asia ex-China, from 4.8% previously to 4.3%, while raising our projection for China to 9.4% from 9.2% (Table 2). The revisions take into account the better-than-expected Q1 outturns and the impact of higher oil prices in line with our baseline commodity projections, and disruptions from Japan. Most of our downward revisions stem from an expected slowdown in Q2, with a rebound thereafter as commodity prices ease and as reconstruction spending in Japan kicks in. In fact, some countries may see an increase in exports to Japan and/or a gain in market share, especially for companies that compete directly in third markets, such as those in Korea.

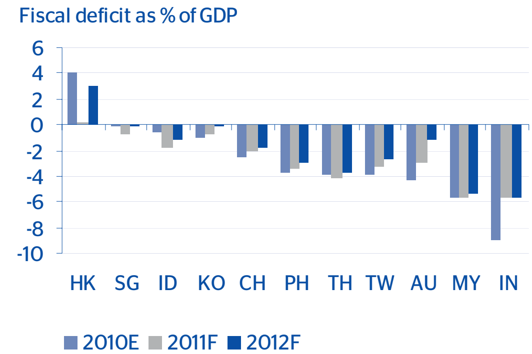
Downward revisions to our 2011 growth forecasts are most notable for Japan, Vietnam and India. For Japan, we expect growth this year to be 0.5%, or 1 ppt lower than our previous forecast, due to disruptions from the earthquake. However, reconstruction spending is likely to lift GDP growth in 2012 by 1.1 ppts to 2.6% from our previous forecast of 1.5%. Our downward revision for India in 2011 (from 8.5% previously to 8.1% at present) is due to the impact of higher oil prices and more aggressive monetary tightening, which appears to be impacting investment spending. In Vietnam, we are adjusting growth down to 6.2% from 6.9% due to a lower-than-expected Q1 growth outturn, and the impact of additional monetary tightening as the authorities struggle to maintain macro stability. In Australia, on the other hand, we are marinating our growth projection of 3.0%. While the economic impact of last January's floods in Queensland will continue to exert downward pressure on GDP growth through the first half of the year, reconstruction spending and the positive terms of trade shock from higher commodity prices should be an offset.

Chart 28
Real interest rates are still negative in a number of economies



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

Chart 29
Most countries are targeting a reductions in fiscal deficits



Source: CEIC and BBVA Research

We are raising our inflation projections, though we expect pressures to remain under control

Given recent trends, we are raising our 2011 average inflation forecast for Asia ex-China to 4.1%, from 3.3% previously. The most significant upward revisions are for Vietnam (to 12.5%), India (8.0%), the Philippines (4.9%) and Singapore (4.1%); in China we are raising our inflation forecast to 4.9%. In Japan, where we anticipate an earlier exit from deflation, we are raising our projection from -0.2% to 0.3% (Table 3). In Australia, however, we are maintaining our previous inflation projection of 3.0% this year, as the impact of January's floods decline during the year, and given the dampening effect of the Australian dollar's recent appreciation. We expect inflation to remain under control as commodity prices ease during the second half of 2011 under our baseline, as supply disruptions that caused food price increases diminish, and as the effects of monetary tightening work to keep inflation expectations in check.

Currency appreciation pressures are expected to persist

We expect further currency appreciation on expectations of capital inflows and monetary authorities' willingness to permit some further currency strengthening to help ease inflation pressures (Table 4). In some cases, however, rising commodity prices will act to worsen the current account balance and limit appreciation pressures, particularly in Korea, Thailand, Taiwan and India, while having the opposite effect among commodity producers such as Australia, Malaysia, and Indonesia. On the monetary policy front, we expect additional front-loaded rate hikes to tame inflation (Table 5).

4. Overheating risks are tempered by headwinds to growth

With Asia's rebound well-entrenched and inflation on the rise, we believe that overheating remains the predominant risk to the region. Headwinds to growth from higher commodity prices and the impact of Japan's earthquake are downside risks. Indeed, we expect activity indicators to begin slowing in the near-term, as already seen in a few cases, such as with PMI readings in China and Korea, among others, and sluggish investment spending in India. However, such headwinds are likely to be temporary as a rebound takes place in Japan in the second half of the year, and as commodity prices ease under our baseline.

Risks to inflation are clearly titled to the upside. If commodity prices fail to ease as anticipated, or if monetary authorities show a reluctance to raise rates, either out of a concern for the growth outlook or so as not to encourage capital inflows, inflation could exceed our projections.

Thanks to Asia's strong economic fundamentals, the region remains well-placed to weather downside risks. In particular, if oil and commodity prices fail to recede as expected, most economies would have ample room to soften the impact through fiscal measures and/or stimulus. For this reason, we estimate the overall impact on growth of a further increase in oil prices to be relatively small. In addition, the region's current account surpluses and high foreign exchange levels would shield economies from the external impact of a further rise in commodity prices. There are, however, exceptions. India, for example, would be more vulnerable given its large fiscal deficit and modest current account deficit.

Country-specific risks also bear watch. Japan will continue to cope with uncertainties related to its nuclear crisis and the fiscal challenges of financing the reconstruction effort. Such uncertainties pose risks for the rest of the region, given the substantial trade and investment flows, although for the reasons discussed above, we believe the overall impact should be small. Thailand will continue to face political tensions in the run-up to general elections now scheduled for July. And overheating risks in Vietnam remain acute, with inflation accelerating and foreign exchange reserves quite low.

5. Tables

Table 2

Macroeconomic Forecasts: Gross Domestic Product

(YoY% growth rate)	2008	2009	2010	2011 (F)	2012 (F)
U.S.	0.4	-2.6	2.9	3.0	2.7
EMU	0.3	-4.1	1.7	1.7	1.5
Asia-Pacific	5.6	3.8	8.0	6.4	6.7
Australia	2.4	1.4	2.6	3.0	3.8
Japan	-1.2	-6.3	3.9	0.5	2.6
China	9.6	9.2	10.3	9.4	9.1
Hong Kong	2.3	-2.7	6.8	4.8	4.5
India	7.5	7.0	8.8	8.1	8.0
Indonesia	6.0	4.6	6.1	6.4	6.7
Korea	2.3	0.3	6.2	4.5	4.5
Malaysia	4.7	-1.7	7.2	5.1	5.4
Philippines	3.7	1.1	7.3	4.5	5.2
Singapore	1.5	-0.8	14.5	5.0	4.8
Taiwan	0.7	-1.9	10.8	5.0	4.9
Thailand	2.5	-2.3	7.8	3.8	4.8
Vietnam	6.3	5.3	6.8	6.2	6.8
Asia ex China	3.0	0.2	6.5	4.3	5.1
World	3.0	-0.6	4.9	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	2.8	2.2
EMU	3.3	0.3	1.6	2.4	1.6
Asia-Pacific	5.7	0.3	3.6	4.4	3.7
Australia	4.4	1.8	2.9	3.0	2.9
Japan	1.4	-1.4	-0.7	0.3	0.5
China	6.0	-0.7	3.3	4.9	4.2
Hong Kong	4.3	0.5	2.4	5.2	3.7
India	8.7	2.1	9.5	8.0	6.5
Indonesia	9.8	4.8	5.1	6.6	5.9
Korea	4.7	2.8	3.0	3.8	3.1
Malaysia	5.4	0.6	1.7	3.0	2.7
Philippines	9.3	3.2	3.8	4.9	4.0
Singapore	6.6	0.6	2.8	4.1	2.8
Taiwan	3.5	-0.9	1.0	1.9	1.5
Thailand	5.5	-0.8	3.3	3.6	3.0
Vietnam	23.2	6.9	10.0	12.5	9.7
Asia ex China	5.5	1.0	3.7	4.1	3.4
World	6.1	2.2	3.7	4.7	4.0

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	1.04	0.95
Japan	JPY/USD	96.1	92.1	81.1	88.0	87.0
China	CNY/USD	6.84	6.83	6.61	6.30	6.00
Hong Kong	HKD/USD	7.75	7.75	7.77	7.80	7.80
India	INR/USD	48.6	46.6	44.7	45.0	44.0
Indonesia	IDR/USD	10838	9395	8996	8600	8800
Korea	KRW/USD	1364	1166	1126	1020	988
Malaysia	MYR/USD	3.56	3.52	3.06	2.88	2.83
Philippines	PHP/USD	48.3	46.8	43.8	43.0	43.0
Singapore	SGD/USD	1.49	1.40	1.28	1.21	1.19
Taiwan	NTD/USD	33.0	32.3	29.3	28.2	27.8
Thailand	THB/USD	34.8	33.3	30.1	31.0	31.0
Vietnam	VND/USD	17433	18479	19498	21500	21500

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	1.25
EMU	2.73	1.00	1.00	1.50	2.00
Australia	4.25	3.75	4.75	5.25	5.75
Japan	0.10	0.10	0.10	0.10	0.25
China	5.31	5.31	5.81	6.81	7.31
Hong Kong	0.50	0.50	0.50	0.50	1.50
India	6.50	4.75	6.25	7.75	7.50
Indonesia	9.25	6.50	6.50	7.25	6.50
Korea	3.00	2.00	2.50	4.00	4.50
Malaysia	3.25	2.00	2.75	3.50	3.75
Philippines	5.90	4.00	4.00	5.00	5.50
Singapore	1.00	0.69	0.48	0.45	1.45
Taiwan	2.00	1.25	1.63	2.13	2.63
Thailand	2.75	1.25	2.00	3.25	3.50
Vietnam	8.50	8.00	9.00	11.00	9.00

Source: CEIC and BBVA Research

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