BBVA | RESEARCH

Economic Outlook

Asia

First Quarter 2012
Economic Analysis

- **The global economy is slowing down, and will only rebound in the second half of 2012**, led by the resurgence of emerging economies. Risks are strongly tilted to the downside as the European sovereign, financial and fiscal crisis continues.

- **Due to the weaker external environment, Asia's growth momentum has continued to slow**. Resilient domestic demand, especially in China, has helped offset weaker external demand.

- **Asia's growth momentum should bottom out in the first half of the year, and rebound gradually in the second half.** We have revised down our 2012-13 Asian growth projections modestly due to the weaker external outlook and the risk of spillovers to domestic demand.

- **Receding inflation has enabled monetary policy to turn more growth-supportive.** There is also room for fiscal stimulus to support growth, especially if downside risks materialize.

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Summary

Asia's growth momentum has continued to slow, as expected, due to the weaker external environment. Fourth quarter growth slowed further in the majority of the region's economies due to lower exports and, in a few cases, from the knock-on effects to domestic demand. However, China's fourth quarter growth surprised to the upside on continued strong domestic demand, providing further evidence that the economy is averting a hard landing. This, together with recent improvements in global risk appetite, bodes well for the region's near-term prospects, despite downside risks from external uncertainties in Europe.

The slowdown in growth has been accompanied by further welcome declines in inflation, which have provided scope for additional monetary policy easing. Continued strong demand from China, healthy underlying fundamentals, and expected policy easing should support Asia's growth in 2012.

We have revised down our 2012 and 2013 growth projections, given the weaker external outlook and risks from the crisis in Europe. For Asia ex-China, we have lowered our 2012 full-year growth projection by about ½ percentage point, from 4.9% to 4.2% in 2012 and from 4.8% to 4.4% in 2013. We have lowered our growth projections for China only modestly, from 8.6% to 8.3% in 2011, and from 8.9% to 8.7% in 2013, given recent signs of continued growth momentum and room for policy stimulus. The revisions are based on a bottoming out of growth momentum in the first half of 2012, followed by a gradual rebound as the external environment improves and on the effects of policy easing.

Risks remain tilted to the downside. Failure to resolve the European debt and financial crisis could have further adverse effects on external demand, with possible spillovers to domestic demand. An intensification of the crisis could result in sharply lower growth outturns from weaker exports and investment. Risks of tighter credit conditions could exacerbate the slowdown, although the region's healthy banking systems appear well-positioned to replace some of the slack from lower credit flows from abroad.

Inflation is receding as a major policy concern. While headline inflation remains on the high side in a few economies, such as Hong Kong, Singapore, India, and Vietnam, it shows signs of receding. In a number of economies, including Korea and Indonesia, inflation has fallen to within official target ranges. Meanwhile, worries about asset price bubbles linger in a few economies, especially with respect to housing prices in Hong Kong, Singapore, and China, with curbs on speculative housing purchases remaining in force even as property prices have begun to decline.

We expect modest interest rate cuts in the coming quarters, along with additional fiscal support to sustain growth. A number of central banks have already eased monetary policy in recent months, including Indonesia, the Philippines, Australia, and Thailand, while China and India have signalled a reversal in their tightening cycles by reducing reserve requirements. We expect modest cuts in interest rates going forward, generally by around 50bps in most economies, with more aggressive cuts likely only if the external environment deteriorates beyond current expectations. Korea and the Philippines plan to front-load their fiscal spending in 2012, and other economies, with the exception of India and Japan where deficit and debt levels are high, have room for fiscal stimulus.

The outlook for financial markets in Asia is highly dependent on the evolution of global risk aversion. There have been strong capital inflows to the region so far in 2012, helping to reverse the selloff and currency weakness of late 2011. The sustainability of this rebound will depend on a satisfactory resolution of the European debt crisis, and firming growth prospects in the US and China. Regional currencies may give back some of their gains so far in 2012, before recovering again in the second half of the year.

1. Global slowdown and a recession in Europe

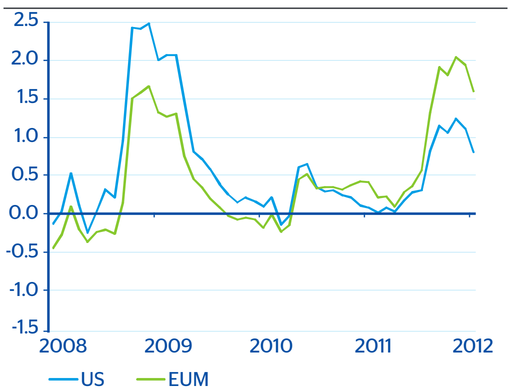
Before turning to Asia, we review the Global Outlook. Readers may go directly to the sections on Asia, if they wish, by turning to page 6.

The global economy slowed down at the end of 2011, but should rebound in the second half of 2012, led by emerging economies

The global economy decelerated markedly in the last quarters of 2011. This was the result of weaker growth in Europe (already negative in Q4) and a deceleration in emerging economies, to around 1% quarter-on-quarter at the end of 2011, their lowest growth rate since the 2008 crisis. However, the drivers of this deceleration differed. Europe has been feeling the effects of persistently high financial tensions since September (see Chart 1), owing to the lack of major advances to solve the sovereign and financial crisis. On the other hand, the slowdown in emerging economies, in addition to the headwinds from developed economies, is partly the result of previous policy tightening through the first half of 2011 to avoid overheating.

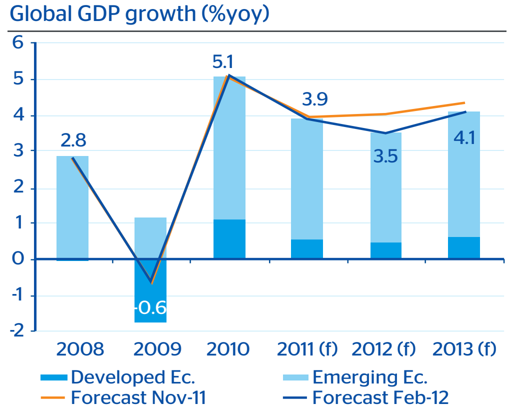
Going forward, decisive action expected by the European authorities should slowly reduce financial tensions and global risk aversion, facilitating a global rebound in the second half of 2012. The biggest contribution to that rebound will nonetheless come from emerging economies, as their policies turn more growth-supportive. At the same time, even though the US will grow more slowly than in previous recoveries, it will decouple from the recession in Europe in the first half of the year. Thus, relative to our previous Global Economic Outlook published in November, we are revising down our forecasts for global growth by 0.6pp in 2012 and 0.3pp in 2013, to 3.5% and 4.1%, respectively (Chart 2).

Chart 1
BBVA Financial Stress Index



Source: BBVA Research

Chart 2
Global GDP growth (%yoy)



Source: BBVA Research and IMF

The euro area is still the main risk to the global outlook

Even after the downward revision of growth rates in Europe and emerging economies, risks remain titled to the downside. These risks hinge on the evolution of the sovereign-financial crisis in Europe, which continues unabated and can potentially deepen the recession there and spill to other regions through trade links, financial exposures and an increase in risk aversion.

Although there have been some advances since October –mainly the provision of long-term liquidity by the ECB and some agreement towards more fiscal discipline– there needs to be more decisive action on three main lines. First, on the sovereign debt front, concerns about the solvency of Greece need to be addressed by completing the deal with private sector bondholders. At the same time, sizable and credible sovereign firewalls should be erected to prevent contagion to less liquid countries. Second, macroeconomic reforms should be pushed forward to raise growth prospects, including those aimed at repairing financial institutions' balance sheets, while taking care to avoid a sudden a reduction in credit to the private sector. Finally, further advances in euro area governance are needed to strengthen the monetary union, including a clear roadmap to a fiscal union.

In line to these three points, European economic prospects would be greatly improved if the agreed fiscal compact were approved at the national level and convincingly implemented after the March EU summit, together with reforms proposed for peripheral countries to reduce their vulnerabilities and increase long-term growth prospects.

Sustained financial tensions have pushed Europe into recession

Financial tensions in Europe continue at levels higher than after the fall of Lehman Brothers in 2008 (Chart 1). Given this, and together with the effect of fiscal adjustment in peripheral countries, we have revised down our growth projections for Europe, incorporating negative growth at least through the first half of 2012, and -0.5% for the year as a whole, with a slow rebound in 2013. It is important to note that these projections depend on a fast resolution of the crisis and a notable reduction of financial stress. The divergence in performance between the core and the periphery in Europe will continue to be wide, partly because of the large fiscal adjustment in the latter.

Contrary to Europe, the US will show resilience in 2012, as in the second half of 2011. Our forecast remains unchanged from 3 months ago, at 2.3% in 2012 and 2.2% in 2013. However, the recovery is weaker than typical post-recession cycles, and is influenced by the risks from Europe as well as the domestic risk of policy uncertainty, including a possible fiscal tightening in 2013 (as tax cuts expire and automatic spending cuts are implemented). In addition, weak housing conditions, tight credit markets and ongoing deleveraging will create headwinds to consumption spending.

Emerging economies are heading for a soft landing

In contrast to the aftermath of the fall of Lehman Brothers in 2008, confidence has remained resilient in emerging economies, including in Asia as described below. This has allowed domestic demand in emerging economies to hold up well, even as some of the effects of increased global risk aversion are felt in financial markets through lower capital inflows, tighter trade finance, and reduced asset prices.

The slowdown in emerging economies during 2011 meant that their growth gap relative to advanced economies was close to 3 percentage points at the end of 2011, somewhat below the historical 4 percentage points since the beginning of the 2000's. We expect global risk aversion to remain high, but ease slowly in the second half of 2012, in line with the expected gradual reduction of tensions in Europe. In addition, economic policies will turn more growth supportive, in contrast with the tightening experienced in the first part of 2011. This will sustain domestic demand in the face of external headwinds from weakness in demand from developed countries. In this context, emerging economies are expected to recover growth rates close to 2% quarter-on-quarter at the end of 2012 (from 1% at end-2011), and grow 6.2% for the year as a whole. The main exception to this good performance will be in emerging markets in Europe, due to their closer trade and financial links to the euro area.

2. Testing Asia's growth resilience

As noted above, growth in emerging market economies, although slowing at present, is expected to lead the global recovery over the course of 2012. Within the group of emerging economies, Asia continues to play an especially important role, with the region having grown by an impressive 7.4% in 2011, despite intensifying external headwinds that have led to a moderation in growth trends in recent quarters (Chart 3).

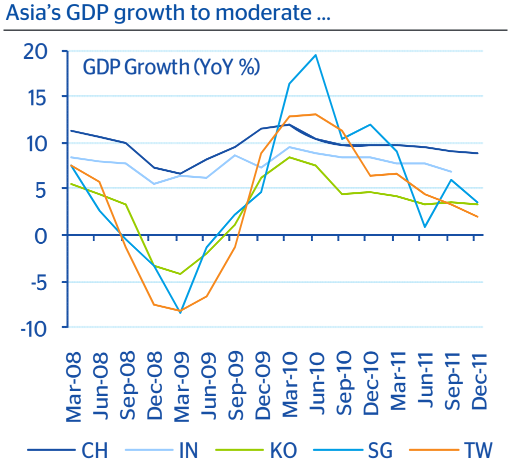
Managing this growth over the past year, however, has not been an easy task. As global uncertainties increased over the course of the year, policymakers had to shift their focus from preventing overheating to supporting growth and guarding against downside risks to the global economy, especially those from the European debt crisis. Interest rate hikes in the first half of the year were put on pause, and by the end of the year a number of central banks had begun easing monetary policy. To varying degrees, fiscal policies also began turning growth-supportive, along with the inclusion of contingency measures in 2012 as a guard against tail risks to the global economy.

The turn to supportive policy stances and sustained credit growth has enabled domestic demand to continue to grow, partially offsetting lower contributions from external demand. As such, the overall slowdown in growth through the end of 2011 has been broadly in line with our projections as set out in the last *Asia Economic Outlook* from November. China continues to play an important role in supporting the region's exports, offsetting weakening demand from Europe (Chart 4) The resilience of domestic demand is also due to the region's sound fundamentals, including sound public finances, strong external positions, and healthy banking systems.

On the basis of these strengths, ratings agencies over the past year have upgraded a number of Asian sovereigns, even as they downgraded developed economies, and despite rising risks to the global economy. In one of the region's most notable upgrades, Indonesia was raised to investment grade by Fitch and Moody's in December and January, respectively. For its part, the Philippines has gotten closer to investment grade with upgrades by Moody's and Fitch to Ba2 and BB+, respectively in June, while S&P raised the country's outlook to 'positive' in December. Korea's outlook was upgraded to positive by Fitch in November, despite uncertainties and spillovers from the political transition in North Korea. Fitch upgraded Australia to AAA in November (bringing it in line with Moody's and S&P). However, not all of the region's economies are on such firm footings, however. Japan, in particular, continues to experience an uneven post-tsunami recovery, with a high public debt burden weighing on sentiment; this contributed to Moody's sovereign downgrade in August, to Aa3.

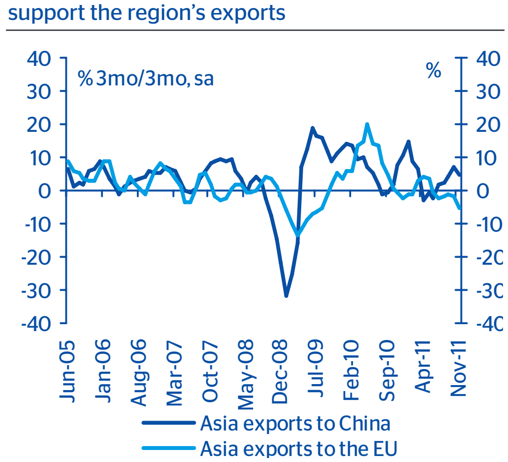
As global headwinds increased, regional growth began to slow more sharply toward the end of 2011. Policymakers responded by shifting their focus from taming inflation to supporting growth. Indonesia (100bps), Australia (50bps), Thailand (50bps) and the Philippines (25bps) have all cut interest rates, taking advantage of the room provided by easing inflation.

Chart 3
The weaker external environment has caused Asia's GDP growth to moderate ...



Source: CEC and BBVA Research

Chart 4
...but demand from China has helped support the region's exports



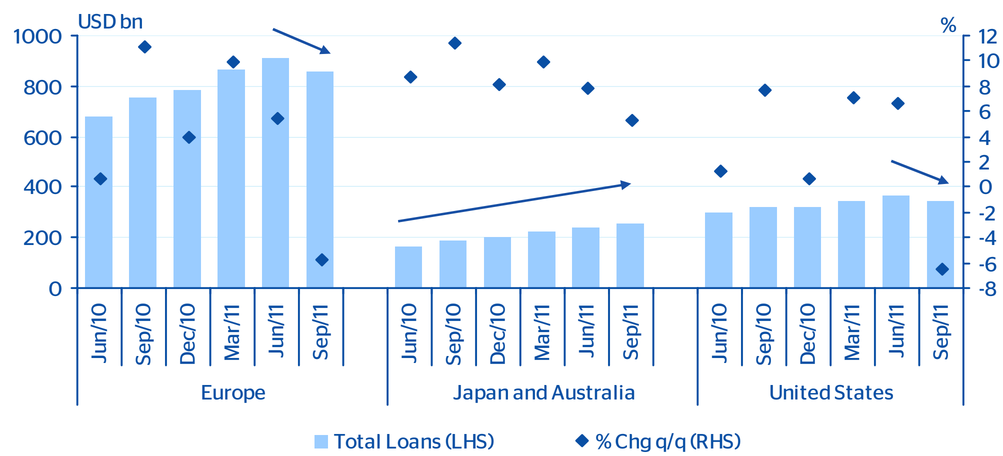
Source: CEIC and BBVA Research

Moderating growth, with support from intraregional linkages

The fourth quarter has witnessed a broad-based slowdown in Asia's growth momentum due to weaker external demand (Chart 3). In sequential terms, China's GDP growth slowed to 2.0% from 2.3% in Q3 (q/q, seasonally adjusted), Korea's to 0.4% q/q sa from 0.5% in Q3, and the economies in Singapore, Taiwan and Indonesia all contracted (by -1.2%, -0.3% and -1.3% q/q sa, respectively). Of the countries reporting thus far, only the Philippines has had an increase in q-on-q growth (from 0.3% in Q3 to 0.9% in Q4), as the government rapidly increases spending to support the economy. Offsetting the slowdown in exports, domestic demand has remained resilient, particularly in China, Indonesia and the Philippines. Korea's more export-oriented economy was a notable exception; domestic demand contracted by -0.3% q/q sa, as Korean businesses scaled back on investment due to external uncertainties.

Providing some offset to weaker external demand from outside the region is deepening intraregional linkages within Asia. For example, Chinese imports from other Asian economies has continued to grow (+3.3% over the most recent 3mo/3mo period in December), with an increasing share driven by final demand (as opposed to processing goods for re-export). There has also been a pickup in intraregional bank lending, including from Japan and Australia, in place of credits from European lenders who are scaling back to shore up capital in their home markets (Chart 5).

Chart 5
Lending by regional banks is picking up as European banks deleverage



Source: BIS and BBVA Research

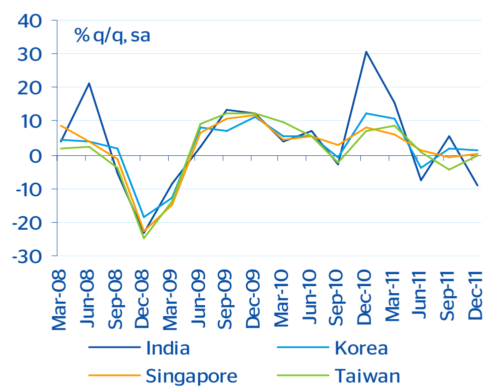
The regional slowdown has not been uniform, and in some cases growth has underperformed relative to previous expectations. Growth in India, in particular, has slowed under the weight of last year's aggressive interest rate hikes to stem inflation. Consumer and business confidence have also been shaken by the sluggish pace of economic reforms, and by India's twin fiscal and current account deficits, all of which contributed to a rapid depreciation of the rupee to historic lows in late 2011, before a rebound early this year as global risk aversion waned. (see Box on "Restoring India's growth," page 14). Additionally, Thailand's economy has slowed sharply, due to the impact of severe flooding in October that disrupted industrial production and supply chains in the auto and electronics sectors.

Japan experienced a quicker-than-expected recovery through Q3 from the March quake and tsunami. However, recent activity indicators such as IP and exports point to a slowdown in growth as exports are being undermined by global headwinds, yen appreciation, supply disruptions from the floods in Thailand (given the dependence of Japanese companies on inputs from Thailand), and power shortages from the shutdown of nuclear facilities. Looking ahead, Japan's recovery is expected to resume, bolstered by the post-quake reconstruction. Public debt remains a concern, at over 225% of GDP, exacerbated by reconstruction spending. Despite all this, growth is expected to resume in 2012, after contracting by -0.4% in 2011.

Weaker external demand has resulted in slowing export growth (Chart 6), with the region's smaller and/or more open economies, for the most part, feeling the slowdown most severely. Taiwan, Korea, and Singapore, in particular, are heavily reliant on export markets in the EU (accounting for 10 percent of total exports, with additional effects from exports of processing goods to China, for production of finished goods destined for the EU). As an example, Singapore's exports to the EU on a year-over-year basis contracted by over 20% in November.

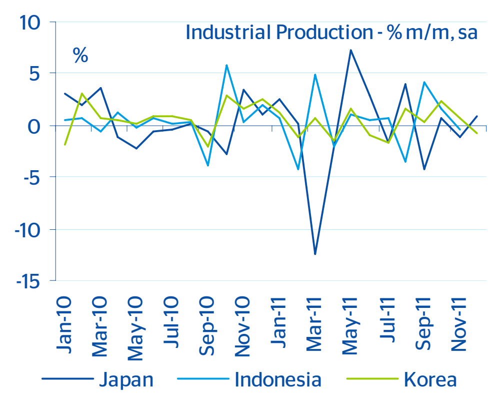
Along with the slowdown in exports, industrial production growth throughout the region has been weakening (Chart 7) as firms cut back in anticipation of weaker orders. Industrial production in Taiwan's electronics-oriented economy contracted by -0.8% q/q sa in Q4. Meanwhile, in Japan industrial production has been weak for the reasons given above (sequential q/q growth in December registered -1.3%) and India has seen industrial production contracting as well, by -1.6% q/q sa in November. PMI outturns have improved slightly through January (Chart 8), and have moved into expansion territory in China (50.5), Australia (51.6) and Hong Kong (51.9) but still show a contraction in Singapore (48.7) and Korea (49.2), as manufacturers remain cautious about the outlook. That said, business confidence has generally weakened throughout Asia (Chart 9). and rising inventory-to-shipment ratios (Chart 10) could signal a weak outlook for production in the months ahead. On the bright side, durable orders are picking up in the US (Chart 11), providing a buffer to weaker demand in Europe.

Chart 6
Export growth has been slowing...



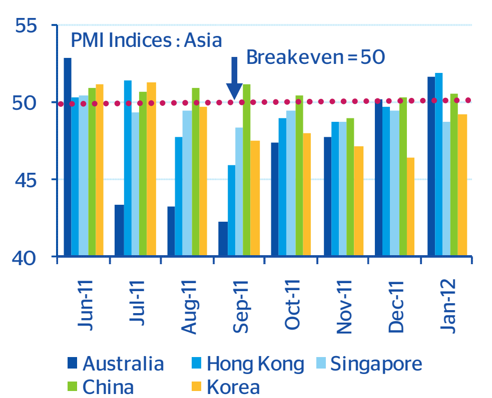
Source: CEIC and BBVA Research

Chart 7
...and the weak outlook is slowing production



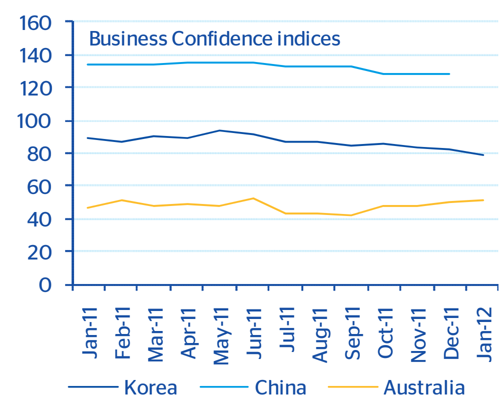
Source: CEIC and BBVA Research

Chart 8
PMI outturns have improved since November....



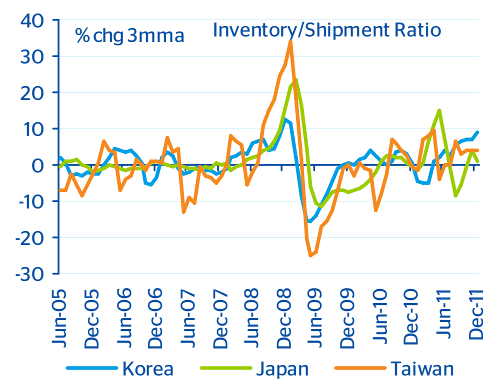
Source: CEIC and BBVA Research

Chart 9
...but overall business confidence is waning



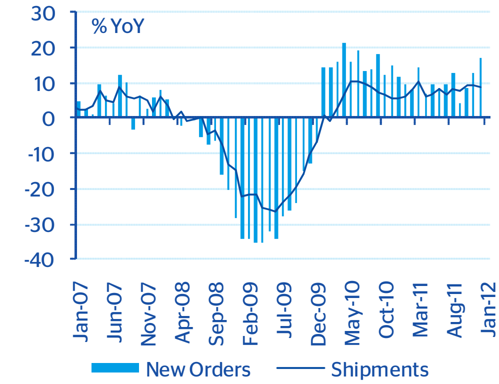
Source: CEIC and BBVA Research

Chart 10
Inventory-to-shipment ratios are increasing



Source: CEIC and BBVA Research

Chart 11
US durable goods orders have picked up



Source: CEIC and BBVA Research

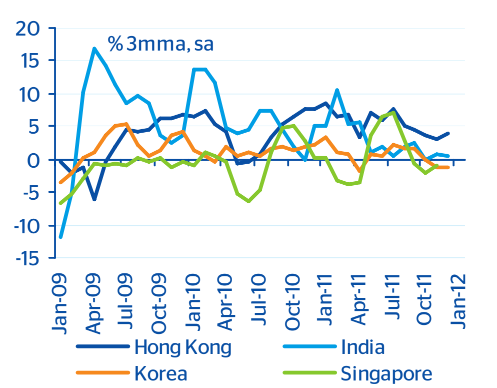
Resilient domestic demand is showing signs of weakening

A key reason for the relative resilience of Asian growth so far has been robust domestic demand. In particular, consumption and investment have held up even in the face of external headwinds, supported by the region's strong fundamentals, healthy banking systems, and low unemployment. Nevertheless, recent data are beginning to show some softness in domestic demand, which could be evidence of spillovers from slower export growth.

Retail sales are trending down (Chart 12), particularly in the more open economies that are susceptible to weakening external demand, such as in Korea and Singapore; Australia is also showing signs of weaker retail sales in the latest data for December. Along with the drop in retail sales, imports are slowing (Chart 13), which could be a sign of weakening domestic demand, especially in light of the trend of declining consumer confidence (Chart 14). However, domestic demand in two of the region's larger and more domestically oriented economies, China and Indonesia, is showing more resilience. Indeed, the strength of domestic demand was a key factor for these countries' robust Q4 GDP outturns.

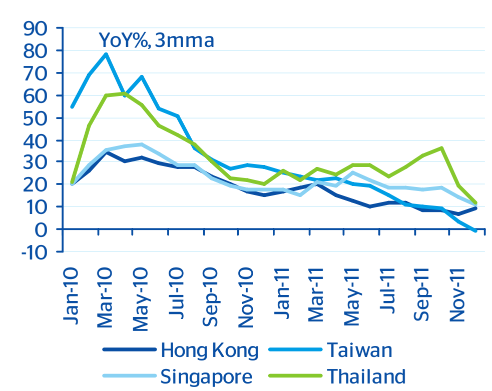
So far, the transmission of a weaker external environment on growth momentum in Asia has been largely limited to the trade channel, with few tangible signs as yet of transmission through the financial channel. As noted earlier, recent BIS data for Q3 2011 reveal signs of some impact of European bank deleveraging on the region (Chart 5, above), but overall banking flows have held up, as regional banks appear to be taking up the slack (Chart 15).

Chart 12
Retail sales growth is moderating...



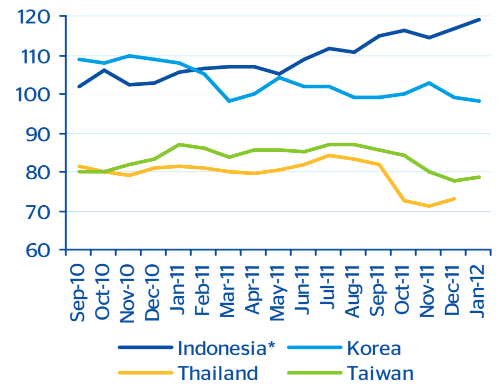
Source: CEIC and BBVA Research

Chart 13
...and imports have been declining



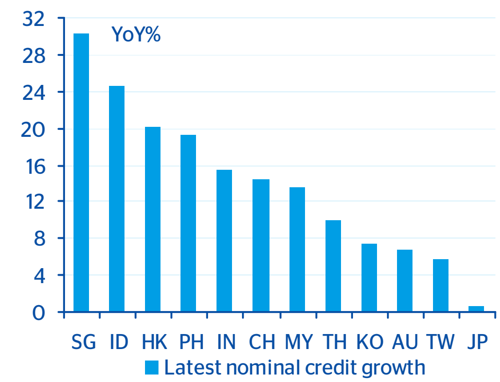
Source: CEIC and BBVA Research

Chart 14
Consumer confidence is weakening...



Source: CEIC and BBVA Research
*Indonesian index courtesy of Bank Indonesia.

Chart 15
...but strong credit growth supports domestic demand



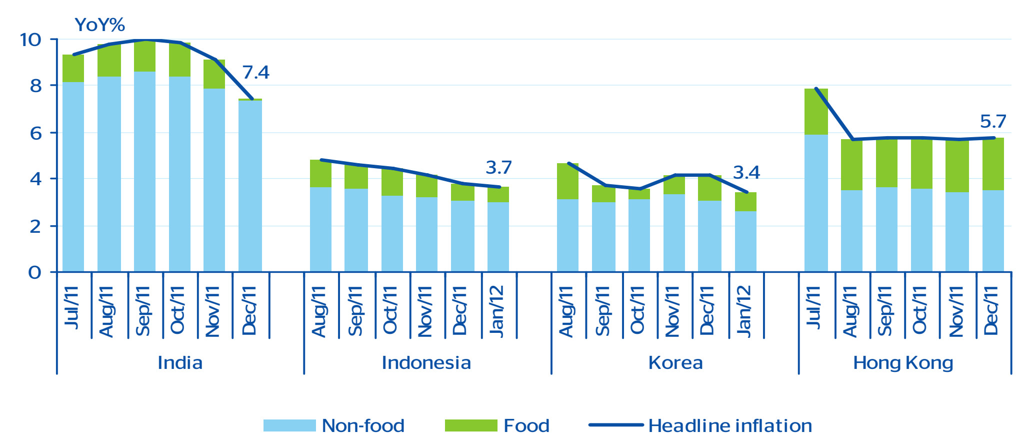
Source: CEIC and BBVA Research

Inflation continues to ease

Along with slowing growth and the abatement of overheating pressures, inflation has continued to subside, although in some cases it still remains above policymakers' comfort zones. Falling food prices, as well as favorable base effects from last year's high price index levels, have contributed to the decline (Charts 16-18). The decline in inflation has been most notable in India, where inflation fell to 7.5% y/y in December after hovering at close to 10% for much of 2011. China has seen an encouraging decline in inflation to around 4% y/y in December (although it picked up to 4.5%y/y in January due to seasonal food price effects), and in Korea, inflation has come back to within official target ranges (2-4% official range), registering 3.4% y/y in January. Vietnam continues to have the region's highest inflation, although even there the trend has been coming down, from a high of 23.0% y/y in August to 18.1% y/y in December, mostly due to falling food prices. Headline inflation through December also remained on the high side in Singapore (5.5% y/y) and Hong Kong (5.6% y/y) due in part to still-high housing and rental costs (rents carry a weight of 30% in Hong Kong's CPI basket). While property prices have fallen after reaching historic highs during 2011, rents have been slower to subside due to the typical lags.

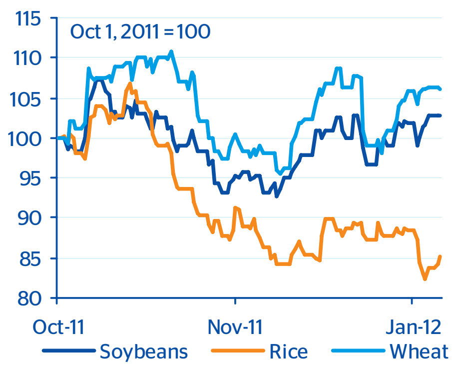
Core inflation rates, which have been sticky over the past year, have also finally shown signs of easing (Chart 19). The decline in core inflation has provided confidence to policymakers to begin reversing monetary policy tightening cycles, with cuts in required reserve ratios in China and India, and interest rate cuts recently in Thailand and the Philippines (Chart 20).

Chart 16
Recent declines in inflation have been broad-based



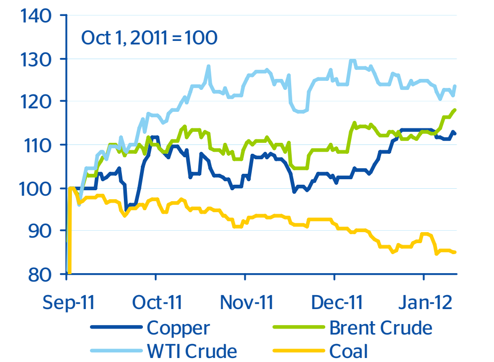
Source: CEIC and BBVA Research

Chart 17
Food prices eased in late 2011...



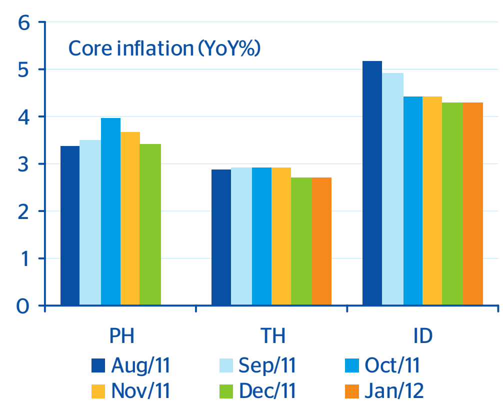
Source: Bloomberg, CEIC and BBVA Research

Chart 18
...but some commodity prices continue to increase



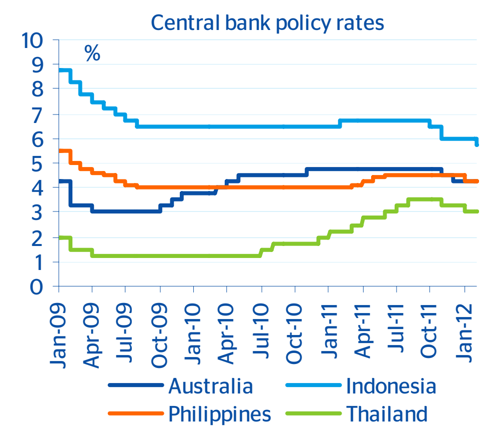
Source: Bloomberg, CEIC and BBVA Research

Chart 19
Easing core inflation...



Source: CEIC and BBVA Research

Chart 20
...has provided room for rate cuts



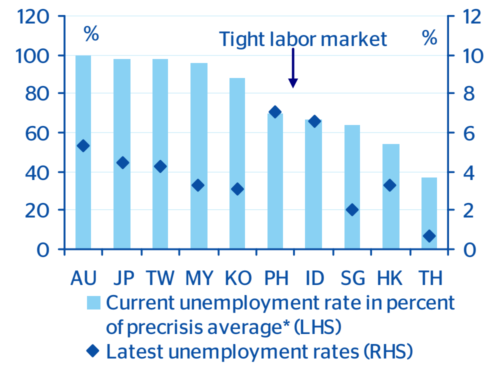
Source: CEIC and BBVA Research

Meanwhile, to help tame housing prices, which have risen for nine straight quarters in Singapore, the authorities have implemented new measures: in particular, beginning in December a 10% stamp duty has been imposed on foreign home purchasers (foreigners account for around 20% of home purchases), along with a 3% rate for second home purchases by permanent residents and third home purchases by citizens. In Hong Kong, where recently property prices have been declining after they reached historic highs in 2011, authorities are still vigilant on the property market, although they have not ruled out the possibility of reversing relevant tightening procedures if property prices fall too quickly.

Monetary easing gathers pace

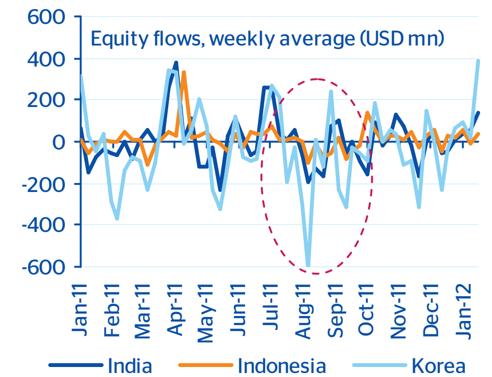
The decline in inflation has provided room for central banks to ease monetary policy to support growth and guard against risks that a worsening external environment may eventually affect labor markets at home, which thus far have remained reasonably resilient (Chart 21). China signalled a shift toward easing at the end of November with a 50bps cut in the reserve requirement ratio, and the Reserve Bank of India did the same in January. A number of other central banks have cut interest rates since Q4, including Indonesia (100bps), Australia (50bps), Thailand (25bps) and the Philippines (25bps), while Singapore eased policy by slowing the pace of its currency appreciation in October (Singapore uses the exchange rate is its monetary policy instrument). A notable holdout has been the Bank of Korea, given still-negative real interest rates and the authorities' discomfort about feeding a further increase in consumer debt.

Chart 21
Labor markets have remained tight



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

Chart 22
Capital flows data: large swings in risk appetite

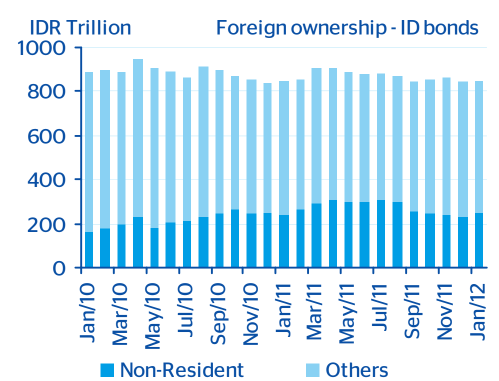


Source: Bloomberg, CEIC and BBVA Research

Asian asset markets rebound after tumultuous third quarter

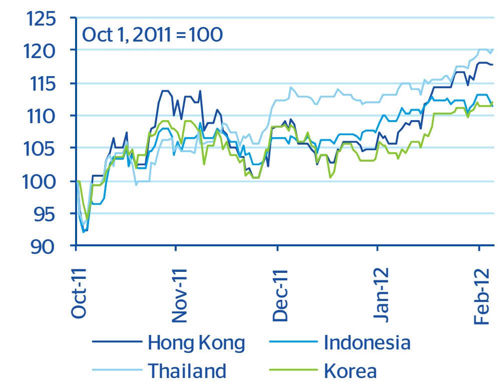
Swings in global risk aversion and capital flows were the key driver of global asset markets in 2011, and Asia was no exception. Outflows were especially large during August and September (Chart 22 and 23) in the aftermath of the US debt stalemate and sovereign downgrade by S&P, and as Europe continued to slip into its growing debt crisis. While equity markets rebounded strongly in the fourth quarter (Chart 24), the full-year performance of the MSCI Asia Pacific Index (-17.4%) trailed other major indices (Chart 25) in Europe and the S&P 500. In December, Korea experienced sharp outflows immediately following the death of North Korean leader Kim Jong Il, but the KOSPI has since staged a strong rebound as investor nerves have calmed. So far in early 2012, the rebound in global risk appetite and easing monetary stances by the US Fed and ECB have resulted in large capital inflows and a rebound in Asian markets and currencies (Chart 26).

Chart 23
Indonesian bonds remain susceptible to outflows



Source: Bloomberg and BBVA Research

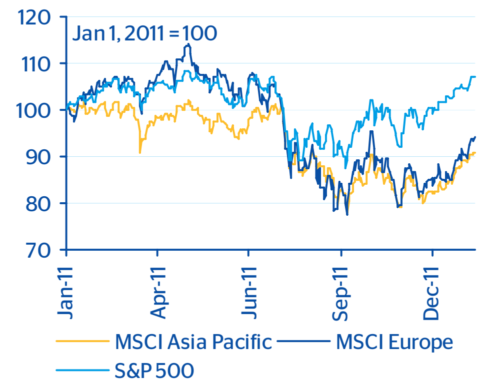
Chart 24
Regional markets rebounded strongly in Q4



Source: Bloomberg and BBVA Research

Chart 25

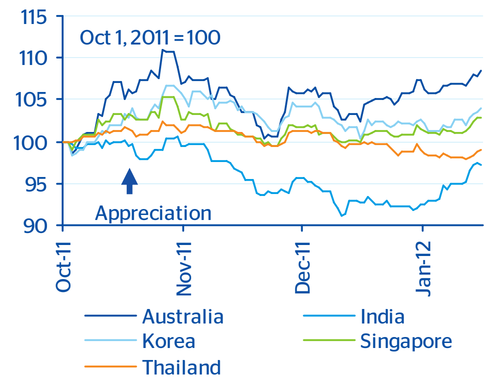
Asia lagged the US and Europe overall in 2011



Source: Bloomberg and BBVA Research

Chart 26

Asian currencies have rebounded into 2012



Source: Bloomberg and BBVA Research

Box: Restoring India's growth

Bright medium-term prospects

India has been one of the world's fastest growing economies since the early 1990s, becoming the world's third-largest economy on a purchasing power parity (PPP) basis (according to the IMF and World Bank), behind the US and China. Among the strengths that make India one of Asia's brightest prospects for medium-term growth and favorites among foreign investors are: favorable demographics, rising income levels, rapid urbanization, a stable and well-regulated financial sector and vast untapped potential in energy, infrastructure, retail and banking. India ranks highly among our group of Emerging and Growth Leading Economies-- "EAGLEs"--and is expected to grow by 8% per year and contribute a whopping 10% of global growth in the coming decade, second only to China (see BBVA Research, "Why Investors Should Focus on BBVA EAGLEs" as well as a forthcoming update to the series).

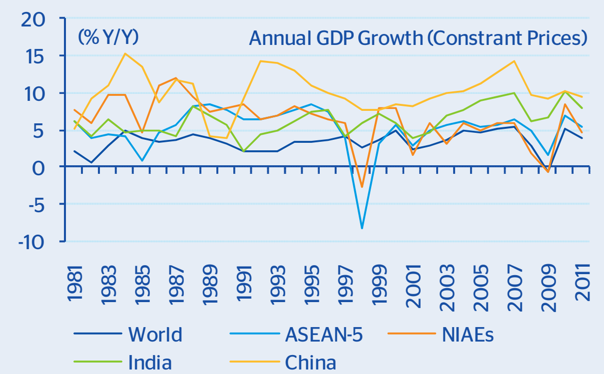
Cyclical slowdown underway

Despite these structural positives, in recent months India's growth has been decelerating and its currency came under pressure in late 2011. As elsewhere in Asia, the slowdown has been due partly to weaker external demand. In India, however, the main factor has been domestic issues, including widening "twin" deficits on the fiscal and the current accounts, high interest rates and inflation, sluggish progress in key policy reforms and administrative red tape. We expect GDP growth to average 7.2% y/y in 2011, well below the 8.7% in the previous year. For 2012 we expect growth of around 7.0% y/y. Reassuringly, headline WPI inflation has softened to 7.5% in December 2011, driven by a sharp fall in food prices, from a near-double digit mark for almost two years. We expect headline inflation to moderate steadily going ahead and average 6.5% y/y in 2012 from 9.2% last year.

Markets are recovering from a sharp selloff

In the near-term, the sharp depreciation of the rupee in late 2011 leaves upside risk to inflation. The depreciation (18.7% against the USD in 2011, making it Asia's worst performing currency) occurred as India's external vulnerability came to fore, with a current account deficit of 3.5% of GDP and high dependence on foreign capital inflows. The currency's losses were further exacerbated by dampened investor sentiment on account of backsliding on key reform initiatives, particularly in the infrastructure and retail fronts. Subsequent forex intervention by the RBI alongside a series of measures to stimulate capital inflows and curb speculative activity in the FX market have helped stem further losses. More recently, the rise in global risk appetite has led to a sharp rebound in the currency. Following sharp declines last year, India's equity markets and the domestic currency have recovered in early 2012.

Chart 27
India: GDP growth rates are among the fastest in the world



Source: CEIC and BBVA Research

However, with the global outlook still fragile and the Indian economy struggling to tackle key challenges, both on the macroeconomic as well a policy front, risks of renewed pressure on equity, as well as forex market, continue to loom large.

Policies to restore confidence

At a time when India needs visible progress on investment reforms and a boost to investment spending, an unhealthy fiscal situation is acting as a potential dampener for private investment. India's fiscal deficit is expected to overshoot the budget estimate for FY12 (5.6% of GDP compared to 4.6% budgeted) amidst subdued revenue growth due to weak tax receipts and excessive public expenditure. The large deficit could potentially crowd out credit flows to the private sector, while further slippages could fuel inflationary pressures in the economy. The onus lies on the government to kickstart fiscal consolidation by paring back subsidies and implementing tax reforms. In this context, the Union Budget for FY13 in March will be closely watched.

Impact on the rest of Asia

At present, the direct impact of the slowdown in India on the rest of Asia is relatively small, and just a fraction of the impact of changes in China's GDP growth. Rather, India's economy is highly dependent on the rest of Asia for imports, investment and capital inflows. Asia constituted around 20% of FDI inflows to India during the year ending March 2011, up from less than 10% in 2007. We expect India to become an increasingly large driver of Asian growth over the coming years, as long as policymakers can successfully address the key challenges the economy faces.

3. Downward growth revisions from weaker external environment

While the recent slowdown in growth trends in Asia has so far been in line with expectations, we have lowered our outlook for 2012 and 2013 modestly due to the weaker global environment. Resilient domestic demand and continued strong growth in China and other emerging markets should provide a partial offset to weaker external demand from developed economies. We expect growth momentum to bottom out in the first half of 2012, and to rebound gradually thereafter as the external environment improves and from the positive effects of policy easing. However, risks remain to the downside due to uncertainties in Europe.

Downward revisions to 2012-13 on weaker external demand

With external headwinds growing stronger due to weaker growth and higher financial tensions in Europe, we have revised downwards our projections for GDP growth in 2012 and 2013 (Table 1). In addition to the direct effects of weaker external demand on export growth, we expect some spillovers to domestic demand which, as noted above, already seems to be occurring in some economies. Policy easing and continued strong growth in China should prevent growth from slowing too far, and help set the stage for a gradual rebound in the second half of the year.

As such, our 2012 GDP forecast for Asia Pacific has been revised downwards from 6.4% y/y previously to 5.8% y/y, and 2013 has been revised down from 6.4% y/y to 6.1% y/y. Our 2012 and 2013 projections for China—an important linchpin of growth for the rest of the region--have been lowered only slightly, to 8.3% y/y and 8.7%, respectively (from 8.6% and 8.9% previously). In particular, China's better-than-expected Q4 2011 growth outturn and room for policy easing have given us further confidence that the economy will avert a hard landing. We have made a more significant downward revision for 2012 in India, to 7.0% y/y from 8.0% previously due to weaker production and investment trends. The downward revisions for most other economies, including for Japan, are on the order of ½ percentage point, with somewhat larger downward revisions for Singapore (from 4.1% y/y to 2.7% y/y), Hong Kong (from 4.1% to 3.1%), the Philippines (to 3.8% y/y from 4.9%), and Thailand (to 4.4% from 5.3%) due to their dependence on exports, and in the case of Thailand due also to the lingering impact of last year's floods.

Notwithstanding these revisions, we continue to hold a positive view on the outlook for the region under our baseline of an improvement in the external environment in the second half of the year. Despite some recent weakening, domestic demand should remain resilient as monetary and fiscal policies turn more growth supportive, and with business and consumer confidence supported by sound underlying fundamentals and strong labor market conditions. Risks, however, are tilted to the downside due to uncertainties about the external outlook, as well as the possibility that domestic demand may be more adversely affected.

Inflation should continue to ease

We expect the moderating trend in inflation to continue in 2012 (Table 2), helped by favorable base effects and further expected declines in food and commodity prices. Based on current trends, we have lowered our 2012 inflation forecast for the Asia-Pacific region to 3.3% from 3.7% previously. Most notably, we expect inflation for the major economies to remain within official target or comfort ranges, which would provide scope for some relaxation in monetary stances to support growth in view of the weaker external environment.

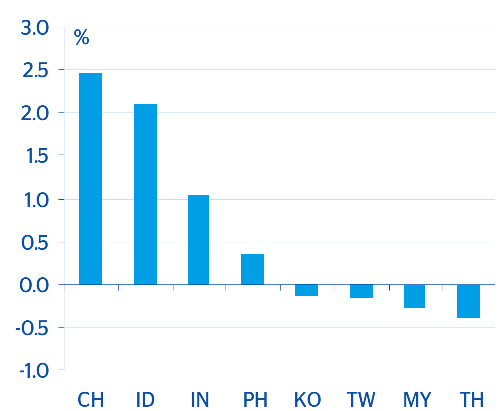
Policymakers likely to be active on both the monetary and fiscal fronts

Central banks throughout the region shifted to policy easing toward the end of 2011, a trend we expect to continue during the first half of 2012 especially as real interest rates are becoming more positive (Chart 28). However, barring a much steeper decline in the external environment than under our baseline, we do not anticipate aggressive easing in any countries given that real policy rates remain near zero or negative in many economies. The Reserve Bank of Australia recently signaled, for example, that it regards the current interest rate level (4.25%) as broadly neutral, and that it will remain on hold if recent improvements in the outlooks for China and the US are sustained. Korea has also held off on interest rate cuts, signaling that it would like to "normalize" interest rates (currently at 3.25%) to help avoid asset bubbles and prevent a further boom in consumer credit.

That said, we expect modest rate cuts throughout the region during the course of the year (Chart 29 and Table 4). Though the outlook for policy rates remains data dependent, we expect further rate cuts of about 50bps on average in Australia, the Philippines, Indonesia, Thailand and Korea. In China, where the authorities signalled the beginning of an easing cycle with the cut in the RRR last November, we expect further such cuts, of around 150bps-200bps by the middle of 2012, with the possibility of up to two interest rate cuts in Q2 and Q3 if external conditions weaken. In India, we expect rate cuts to commence in late Q1 or Q2 due to falling inflation and slowing growth momentum.

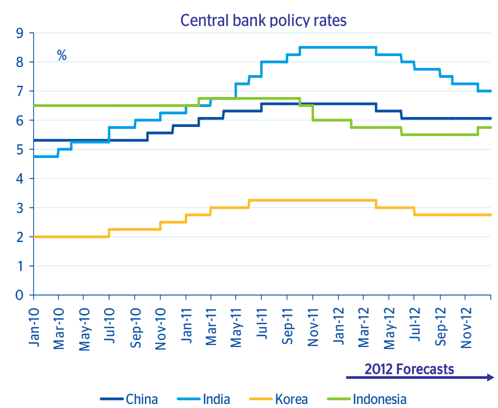
In China, where the room for stimulus on par with 2008-09 is now more limited, we expect fiscal support to be oriented to priority spending in construction of affordable housing, infrastructure projects in water distribution, as well as tax cuts and subsidies to consumption. Many other economies are also expected to increase spending on much-needed infrastructure, including the Philippines and Indonesia. Hong Kong has unveiled a number of popular measures in its recent FY 2012/13 budget proposal (to be approved by the Legislature in March), including tax redemptions and electricity tariff subsidies, as well as increased support for SMEs and infrastructure projects. Korea, on the other hand, has shown some reluctance for the time being to adopt a supplementary budget, opting so far to front-load spending in the first half of the year. Japan, meanwhile, faces constraints due to its high public debt level, but post-earthquake construction will continue in 2012, providing further support to the economic recovery.

Chart 28
Real interest rates are increasing



Source: CEIC and BBVA Research

Chart 29
We expect more rate cuts in 2012



Source: CEIC and BBVA Research

Currencies should strengthen if risks from Europe are contained

The outlook for Asian currencies depends critically on the evolution of risk aversion for the remainder of 2012. Developments through the early part of 2012 have favored Asian currencies, but it is questionable whether these trends will be sustained in the near term. Notwithstanding the recent rebound in the region's currencies, given the weak external outlook for the first half of 2012, we expect most currencies to give back some of their recent gains in the near term. We would expect appreciation trends to reassert themselves in the second half of the year as the global environment improves (Table 3). This outlook also holds for the RMB, where we expect full-year appreciation against the USD to slow to around 3%, compared to 5% in 2011, mostly titled toward the second half of the year. Volatility will remain high, pending a resolution of the European crisis.

4. Downside risks to the outlook

Uncertainties about the global outlook continue to pose downside risks to our projections for 2012-13, especially due to the ongoing debt and financial crisis in Europe. If heightened financial tensions in Europe were to persist beyond mid-year, or if downside risks to the outlooks in China or the US were to materialize, growth in Asian economies would slow down by much more than projected under our baseline.

The region's smaller and more export-oriented economies would be hardest hit through reduced exports, stemming from weaker external demand and, in the event of a more severe crisis in Europe, possible disruptions to trade finance. The impact on the financial centers of Hong Kong and Singapore could be particularly hard-hit in such a case. More generally, the economies with open capital accounts and dependence on foreign borrowing, such as Korea, Indonesia, and Australia would be relatively exposed to an abrupt stoppage in international capital flows. That said, the region's strong underlying fundamentals, including high foreign exchange reserves, well capitalized banking systems, and room for policy stimulus should help counter these risks, as is evident already from the region's resilience through the end of 2011.

Even under our current baseline, there is a risk that domestic demand may weaken by more than expected due to adverse spillovers from slower export growth. Evidence of this is already apparent in the case of Korea, for example, where investment and consumption weakened by more than expected in Q4 2011. The region's larger economies, especially China and Indonesia, are better positioned to sustain strong demand. India is also well-positioned, although recent weakness in its domestic economy leaves it more exposed than was the case during our previous quarterly update.

Geopolitical risks also bear watch. Rising tensions with Iran could have adverse impacts on the oil market which could, in turn, reverse the healthy declines in Asian inflation. It could also put pressure on the region's energy importing economies, especially India and Japan.

Country-specific risks include the uneven pace of recoveries in Japan and Thailand from their respective natural disasters 2011. Although both economies are on now on the mend, power shortages, weak business sentiment, high public debt and external headwinds continue to plague the recovery in Japan; the electronics and automotive industries in Thailand are also facing uncertainty about how quickly they can commence production. The political transition in North Korea will continue to be a source of investor concern, and in the near term will add to uncertainty in the South, which will face Presidential elections later this year. Meanwhile, India is coping with slowing growth momentum and weak sentiment from the sluggish pace of reform. Its "twin" deficits and still-high inflation limit the room for policy manoeuvre. Finally, while risks of a hard landing have receded in China, its ability to sustain high growth will be challenged in the face of strong external headwinds and domestic financial fragilities.

Political uncertainty will remain on the table in 2012 through parts of the region. A new Chief Executive will be appointed in Hong Kong in late March, and Korea will hold Presidential elections in December. There will also be a leadership change in China beginning in October and culminating in March 2013 with a new President and Premier. All else equal, the forthcoming changes could make the authorities more likely to use stimulus measures to support growth and maintain stability in 2012 in advance of the leadership transition. Meanwhile, political tensions over the future course of cross-strait ties have eased in Taiwan, following the re-election in January of incumbent President Ma Ying-jeou, which bodes well for further economic integration with the Mainland.

5. Tables

Table 1

Macroeconomic Forecasts: Gross Domestic Product

(YoY% growth rate)	2009	2010	2011 (F)	2012 (F)	2013 (F)
U.S.	-3.5	3.0	1.7	2.3	2.2
EMU	-4.2	1.8	1.6	-0.5	1.0
Asia-Pacific	4.2	8.1	5.8	5.8	6.1
Australia	1.5	2.4	1.8	3.2	3.4
Japan	-5.5	4.4	-0.4	2.2	1.3
China	9.2	10.4	9.2	8.3	8.7
Hong Kong	-2.7	7.0	4.8	3.1	4.3
India	9.1	8.8	7.2	7.0	7.4
Indonesia	4.6	6.1	6.5	6.2	6.4
Korea	0.3	6.2	3.6	3.0	4.0
Malaysia	-1.6	7.2	4.5	4.4	5.1
Philippines	1.1	7.6	3.7	3.8	4.7
Singapore	-0.8	14.5	5.0	2.7	4.7
Taiwan	-1.9	10.8	4.1	3.3	4.5
Thailand	-2.3	7.8	1.8	4.4	5.2
Vietnam	5.3	6.8	6.2	5.9	7.2
Asia ex China	1.0	6.7	3.5	4.2	4.4
World	-0.6	5.1	3.9	3.5	4.1

Source: CEIC and BBVA Research

Table 2

Macroeconomic Forecasts: Inflation (Avg.)

(YoY% growth rate)	2009	2010	2011 (F)	2012 (F)	2013 (F)
U.S.	-0.3	1.6	3.2	2.3	2.3
EMU	0.3	1.6	2.7	1.8	1.3
Asia-Pacific	0.3	3.6	4.8	3.3	3.4
Australia	1.8	2.8	3.4	2.6	2.6
Japan	-1.4	-0.7	-0.3	-0.2	0.2
China	-0.8	3.3	5.4	3.3	3.7
Hong Kong	0.6	2.3	5.3	4.5	3.6
India	2.4	9.6	9.4	6.5	5.8
Indonesia	4.8	5.1	5.4	5.2	5.4
Korea	2.8	3.0	4.0	3.2	3.6
Malaysia	0.6	1.7	3.1	2.5	2.5
Philippines	3.2	3.8	4.4	3.7	4.2
Singapore	0.6	2.8	5.2	3.0	3.6
Taiwan	-0.9	1.0	1.4	1.1	1.5
Thailand	-0.8	3.3	3.9	3.7	3.0
Vietnam	6.9	10.0	18.6	12.4	8.8
Asia ex China	1.0	3.7	4.4	3.3	3.1
World	2.2	3.0	5.1	3.9	3.6

Source: CEIC and BBVA Research

Table 3

Macroeconomic Forecasts: Exchange Rates (End of period)

		2009	2010	2011	2012 (F)	2013 (F)
U.S.*	EUR/USD	0.72	0.76	0.72	0.80	0.79
EMU*	USD/EUR	1.39	1.33	1.39	1.26	1.27
Australia	USD/AUD	0.90	1.02	1.02	1.02	0.98
Japan	JPY/USD	92.1	81.1	76.9	84.0	90.0
China	CNY/USD	6.83	6.61	6.30	6.11	5.80
Hong Kong	HKD/USD	7.75	7.77	7.77	7.80	7.80
India	INR/USD	46.6	44.7	53.06	49.00	46.50
Indonesia	IDR/USD	9395	8996	9069	8900	8900
Korea	KRW/USD	1166	1126	1152	1100	1050
Malaysia	MYR/USD	3.52	3.06	3.17	3.05	2.90
Philippines	PHP/USD	46.8	43.8	43.80	43.00	41.00
Singapore	SGD/USD	1.40	1.28	1.30	1.23	1.22
Taiwan	NTD/USD	32.3	29.3	30.28	30.20	29.60
Thailand	THB/USD	33.3	30.1	31.55	30.50	30.50
Vietnam	VND/USD	17942	19498	21034	21500	22000

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

Table 4

Macroeconomic Forecasts: Policy Rates (End of period)

(%)	2009	2010	2011	2012 (F)	2013 (F)
U.S.	0.25	0.25	0.25	0.25	0.25
EMU	1.00	1.00	1.10	0.75	0.75
Australia	3.75	4.75	4.25	3.75	4.50
Japan	0.10	0.10	0.10	0.10	0.25
China	5.31	5.81	6.56	6.06	6.56
Hong Kong	0.50	0.50	0.50	0.50	1.25
India	4.75	6.25	8.50	7.00	6.00
Indonesia	6.50	6.50	6.00	5.75	6.25
Korea	2.00	2.50	3.25	2.75	3.25
Malaysia	2.00	2.75	3.00	2.50	3.00
Philippines	4.00	4.00	4.50	4.00	4.00
Singapore	0.69	0.48	0.45	0.40	0.40
Taiwan	1.25	1.63	1.88	1.63	2.13
Thailand	1.25	2.00	3.25	3.00	3.50
Vietnam	8.00	9.00	9.00	9.00	9.00

Source: CEIC and BBVA Research

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