BBVA | RESEARCH

Economic Outlook

Asia

Fourth quarter 2012
Economic Analysis

- **Bold policy actions by central banks have reduced uncertainties in the global outlook, but challenges remain.** The world economy is expected to continue its soft recovery, with GDP growth of 3.5% in 2013, up from 3.2% in 2012.

- **While growth momentum in Asia has continued to slow, domestic demand has been robust, and there is room for further policy easing.** We have therefore made only small downward revisions to our Asia growth projections, and our outlook for subdued inflation remains unchanged.

- **We expect growth to pick up in the current quarter and in early 2013.** Indeed, recent data, especially in China, suggest this may already be happening. Going forward, the pickup should be sustained by an improving external environment, along with supportive policies.

- **Risks to the outlook remain to the downside.** In addition to uncertainties in Europe, and the sluggish growth outlook in the US, geopolitical tensions within the region risk putting further downward pressures on growth momentum.

Index

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Summary

Asia's growth momentum has continued to slow due to the weak external environment and, to a lesser extent, from domestically generated factors in China, India, and Japan. Despite the slowdown, labor market conditions remain tight and domestic demand has weakened less than proportionately with support from policy easing. We expect growth momentum to pick up gradually during the rest of the year – as is already evident from recent activity indicators in China and elsewhere in the region – on the effects of further policy easing and an improvement in external conditions. However, risks remain to the downside given the uncertain global outlook from weakness in Europe and the prospect of the fiscal cliff in the US.

While lowering our growth projections modestly in view of weaker third quarter outturns, we continue to expect a pickup in 2013 for most countries. To date, the growth slowdown has been most pronounced in the region's larger economies, including China, India, and Japan, as well as in some of the region's most export-dependent economies such as Korea, Singapore, and Taiwan. In contrast, growth has held up relatively well in Southeast Asia. Our growth projections for Asia Pacific are now 5.2% and 5.5% for 2012 and 2013 (previously 5.4% y/y and 5.8% y/y, respectively). For 2013, the most significant revisions are for China (to 7.9% y/y from 8.3% y/y) and India (to 6.7% y/y from 7.1% y/y).

With price pressures remaining subdued, our outlook for inflation is broadly unchanged from previous projections. Inflation touched multi-year lows in the third quarter for a number of economies, including China and Korea on weak demand and lower commodity prices. That said, inflation remains elevated in a few countries, such as in India and Singapore. Moreover, given tight labor market conditions and expected inflows from QE3, inflation could easily reappear if economic growth picks up beyond that envisaged in our baseline.

Policymakers have responded to the growth slowdown with cautious monetary easing. While there is scope for further easing in light of subdued inflationary pressures, the cautious pace of interest rate cuts reflects policymakers' preference to save room if external conditions deteriorate, as well as the presence of still-high capacity utilization and tight labor markets. Going forward, we expect further monetary easing in China, India, and Japan (through further expansions in the BoJ's asset purchase program), and there remains room in other economies, such as Korea and Australia, should growth weaken further.

Fiscal stimulus has been used somewhat sparingly as policymakers seek to maintain healthy budget balances. China has stepped up infrastructure spending, and there have been modest stimulus packages announced in Korea and Japan. Otherwise, though policy stances remain generally growth supportive, policymakers have sought to consolidate budget balances after the stimulus measures that were put in place to counter the 2008-09 global financial crisis. Should downside risks to the outlook materialize, there would be room in most economies for further fiscal stimulus measures.

Risks remain to the downside given uncertainties in the external environment. Though recent policy steps have been positive, a backtracking in the resolution of the European crisis remains the primary risk to the outlook. In addition, sluggish growth prospects in the US will continue to weigh on Asian export prospects, exacerbated by risks of the fiscal cliff toward end year. If these external risks materialize, growth in Asia could be around one percentage point lower, after accounting for the effects of additional policy easing, with the impact significantly higher in the more open economies such as Hong Kong. Within the region, a continued slowdown in China is a risk (though it is receding), as are geopolitical tensions between China and its neighbors, especially with Japan.

Despite these risks, the outlook for Asian financial markets is generally good. Capital inflows are on the rise following an improvement in global risk appetite and an associated increase in global liquidity from recent actions by the ECB, the US Fed, and the BoJ. While regional equity and currency markets will continue to be influenced by global developments, under our baseline of an improving external environment we would expect Asian markets to strengthen in 2013.

1. Central bank actions reduce tail risks

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 7.

Bold actions by central banks have reduced uncertainties in the global economic outlook, but challenges remain

The world economy is expected to continue its soft recovery, with GDP growth of 3.5% in 2013, up from 3.2% in 2012. The outlook is supported by lower risk aversion after influential decisions taken by central banks, especially the ECB. However, three factors stand out that could undermine the outlook: first is the risk of a re-emergence of euro break-up fears; second is the threat of the so-called US fiscal cliff (a spending-cut and tax-hike package worth 4% of GDP) due to take effect at the beginning of 2013 that would push the US economy back into recession; and third, is the risk of a slowdown in the emerging economies, especially in China.

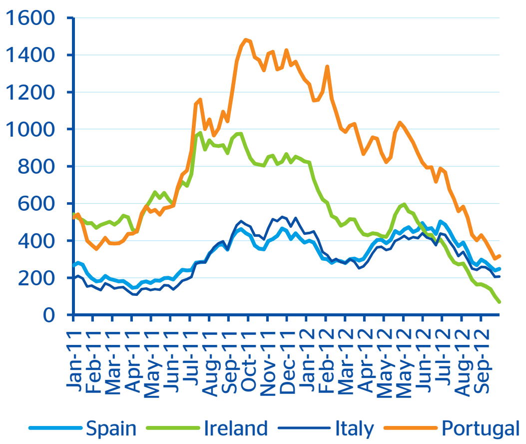
Central banks to the rescue; other policy makers should follow

Against a backdrop of uncertainty and threats to the world economy, policy makers – in particular central banks in the eurozone and the US – have taken steps to avert a systemic event that could have been comparable in scale to the financial crisis of late 2008.

"… whatever it takes…"

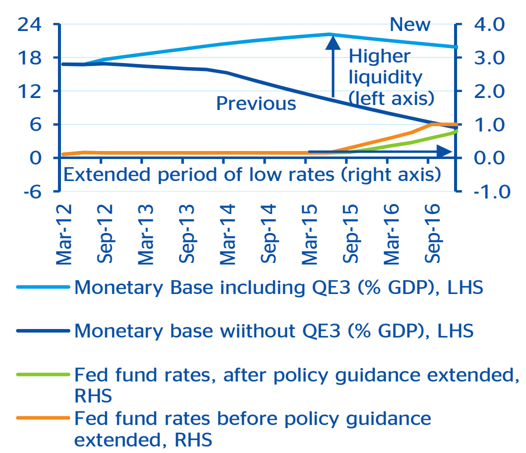
In our view, European Central Bank (ECB) President Mario Draghi's announcement of a new bond-purchase program (Outright Monetary Transactions, or OMT) in late July was a decisive step toward ending the debt crisis in Europe. Under certain conditions, the ECB could intervene in secondary sovereign-debt markets. The ECB's move came after a eurozone summit in June where leaders reached agreement on a broad roadmap towards a single banking supervisor, far-reaching plans on fiscal issues, and growth-supporting measures. The ECB has committed itself to buy unlimited quantities of sovereign bonds of those countries that seek financial aid from Europe's funds (European Financial Stability Fund & European Stability Mechanism) with "strict and effective conditionality." Tensions in financial markets have eased significantly since June (see Chart 1).

Chart 1
Financial Stress Index for Eurozone countries[1]



Source: Haver and BBVA Research

Chart 2
QE3 and extended policy guidance



Source: BBVA Research

[1] The Financial Stress Index (FSI) is a synthetic indicator of: risk measures (5-year CDS, CDS of non-financial corporations and financial debt), volatility (stocks, interest rates and exchange rates) and liquidity stress (3-month spread between interbank and risk-free asset).

Other elements have recently reinforced the currency union in Europe. First, the permanent fund that will deal with any new bailout in the eurozone (the ESM) has been put in place. Second, the process for achieving a banking union in Europe continues moving forward, albeit slowly.

We expect the eurozone to come up with a full package eventually that will reinforce its governance. As we have long argued, such a package should comprise a banking union, a fiscal union, and a lender of last resort facility. Progress has been made on all of these fronts which, though not ambitious enough yet to revert the current dynamic quickly, will alleviate pressures over time. In the short term, the ECB's program and the ESM support under fiscal conditionality creates a benchmark to deal with difficult funding situations that countries such as Italy and Spain could face. At the same time, effective implementation of the banking-union plans and further definition of the fiscal-union design will be key to the long-term sustainability of the eurozone.

"... as long as needed..."

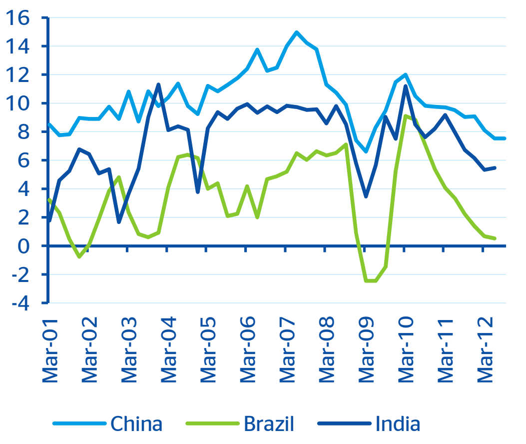
With the US economy growing slowly, unemployment remaining persistently high, and amid huge uncertainty in Europe, a pre-electoral gridlock over how to bring the US deficit down was the last thing the US economy needed. Against this backdrop, the Fed did not hesitate to act. First, and in accordance with its "forward-guidance policy," the Fed announced that it intends to keep rates at their current low levels until at least mid-2015. Second, the Fed announced a new round of quantitative easing (QE) to support growth and employment recovery. This further monetary loosening will be different from previous rounds: the Fed will purchase mortgage-backed securities (MBS) rather than Treasuries, and it will continue with this policy for a considerable period of time, even after the recovery strengthens.

In our view, by embarking on QE3 and extending policy guidance, the Fed is buying insurance against the "fiscal cliff," but it is not a silver bullet. In our baseline scenario, an agreement will be reached to avoid the complete package of automatic spending cuts and tax hikes from taking place. Yet we also expect some form of fiscal consolidation that will act as a drag on growth. The Fed has done its part to give the economy the boost it needs to avoid slipping back into recession in 2013. As previous QE programmes showed, they prompt inflows to emerging economies, decreasing risk premia, and lowering funding costs.

Central bank responses are not enough for a firm expansion

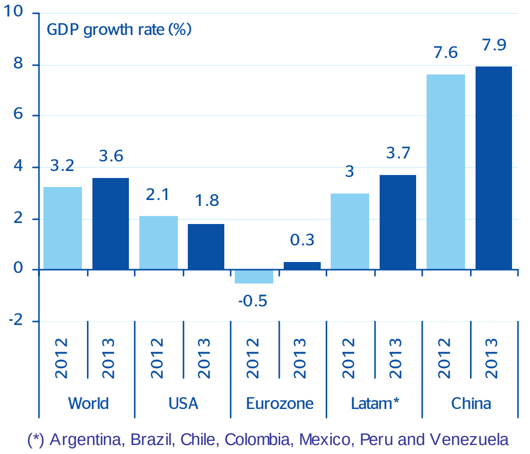
The world economy may have avoided decelerating to its slowest growth of the last 30 years (apart from the 2009 great recession) but a low growth environment continues. The advanced economies have been losing momentum since 2011. More recently the emerging economies have been hit too (see Chart 3). Brazil's economy almost stalled in the first half of the year; India's GDP grew by 5.3 and 5.5% y/y in the first and second quarter, respectively, the slowest pace since the beginning of 2009; and in the third quarter of the year the Chinese economy slowed to a rate of 7.4%, the lowest growth rate since 2009 although the more recent data points to a bottoming-out.

Chart 3
Emerging economies GDP growth rate (% y/y)



Source: Haver and BBVA Research

Chart 4
GDP Growth rate (%)



Source: Haver and BBVA Research

Under our baseline scenario, growth in the eurozone is likely to gain momentum in 2013. Although GDP will contract in 2012 (-0.5%), it should rebound slightly in 2013 (+0.3%). In the US, we have maintained our forecasts: growth will remain at around 2% in 2012 and 2013. The main downward revision in our October scenario corresponds to China (by -0.2 pp in 2012 and -0.4 pp in 2013), although its growth rate will still remain close to 8% in both years due to policy stimulus. Other emerging economies will make up for this slack: the outlook for growth in Latin America is revised slightly upwards in 2013, when the region will grow by 3.7%, up from a 3% growth rate in 2012.

All in all, the world economy is expected to continue undergoing a soft recovery with a GDP growth between 3% and 3.5%. Yet this scenario relies on several key assumptions, in particular on whether European policy makers will deliver on their commitments. In the meantime, the ESM/ECB's intervention should be enough to bring Spanish and Italian yields back to levels consistent with the mid-term sustainability of the public debt. This implies that both countries retain investment-grade ratings and deliver on their fiscal commitments (or are granted extensions to meet them, hopefully on structural balances). Finally, in this scenario, Greece should remain in the euro, which would, in turn, require further support from Europe in the form of additional funding and/or a longer period to fulfil fiscal conditionality. Based on past experience, many things can still go wrong, but policy makers have shown a tendency to find solutions when crunch time approaches.

2. How is Asia's growth momentum faring amidst global headwinds?

With global headwinds persisting, Asian economies continued to slow in the third quarter of 2012, in some cases by more than previously expected. Despite resilient domestic demand—fed by strong labor markets and sustained credit growth—particularly in Southeast Asia (ASEAN economies), weak external conditions have suppressed exports, especially to the EU, which remains a major market for Asian products (Chart 5). Slowdowns in the region's largest economies, notably China, Japan, and India, have added further downward pressure on growth throughout the region. As such, third quarter GDP outturns continued to weaken throughout Asia, although there are tentative signs in recent high frequency indicators that growth momentum may be rebounding.

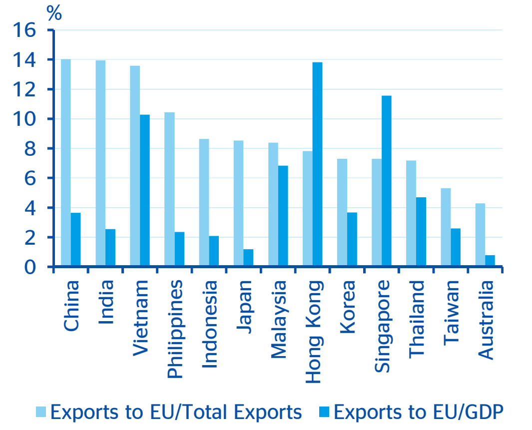
Policy settings have been increasingly growth supportive. Monetary conditions remain accommodative across the region, and a number of central banks have recently eased policy further in view of declining inflation and weaker domestic growth outturns. Fiscal policy, on the other hand, has been used more sparingly. While there remains room in a number of countries, policy makers have generally preferred to keep previous fiscal consolidation plans intact. There have been exceptions, most notably in Korea, which announced US$12.9bn (about 1.1% of GDP) in stimulus measures in the third quarter; in China, where infrastructure spending is being stepped up to counter the economic slowdown; and to a more limited extent in Japan, where the room for fiscal stimulus is constrained by already-high deficit and debt levels.

Policy makers have not so far shown a sense of urgency to counter the ongoing slowdown. There are a number of reasons, most significantly that output gaps remain small - as evidenced by tight labor markets and high rates of capacity utilization (Chart 6). Also, the slowdown has been gradual and has come after a period of overheating in 2010 and early 2011. As such, policymakers may be saving room for further easing as a safeguard against ongoing downside risks to the external outlook.

Moreover, there are tentative signs that growth may be stabilizing. Most notably, September activity indicators in China were stronger than expected. Exports also picked up in a number of economies that had recently showed disappointing outturns, including in China, Korea (in October), and Taiwan. Externally, positive policy steps, such as QE3 in the US, a promise of sovereign bond purchases by the ECB, and further monetary easing in Japan have also improved risk appetite, leading to renewed capital inflows to the region.

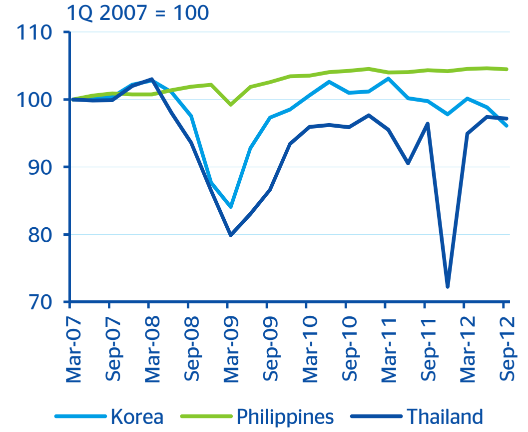
Adding to the improving mood caused by these data outturns are a number of positive regional developments. India has commenced much-needed policy reforms, and Hong Kong and Singapore are taking steps to solidify their roles as leading financial centers. The major rating agencies have rewarded Korea with new sovereign upgrades in recognition of its improving fiscal strength and reduced vulnerabilities (the Philippines was also upgraded by S&P in July, and by Moody's in late October). Thus, though short-term growth momentum has been stunted by external headwinds, the region's medium-term fundamentals remain sound. Of new concern, however, are rising tensions between China and its neighbors that, if not resolved quickly, could spillover and have detrimental effects on regional trade and investment flows (see Box on page 16).

Chart 5
Europe is a major market for Asia's exports



Source: CEC and BBVA Research

Chart 6
Asia is still running at high capacity utilization



Source: CEIC and BBVA Research

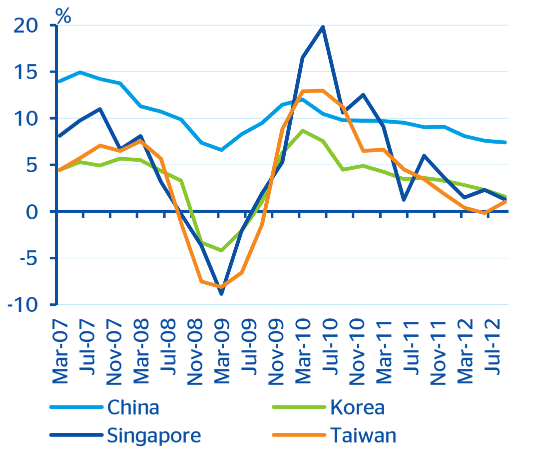
Growth in export-dependent economies remains under pressure

Third quarter GDP outturns released so far show a continued slowdown (Chart 7) by somewhat more than anticipated in our last *Quarterly Outlook* published in August. In particular, China's growth fell to 7.4% y/y in the third quarter from 7.6% y/y in the second quarter. However, sequential growth actually picked up to 2.2% q/q from 2.0% q/q according to official data, and a pickup in September activity indicators – most notably exports, retail sales, urban fixed asset investment, and loan growth – has raised confidence that growth has bottomed out on the effects of policy easing put into place earlier this year.

Meanwhile, Korea's GDP growth slowed in the third quarter to 1.6% y/y, from 2.3% in the previous quarter (equivalent to 0.2% q/q s.a. from 0.3% q/q sa in the second quarter), on weak investment. The slowdown prompted the Bank of Korea in early October to revise its growth estimates for 2012 and 2013 to 2.4% and 3.2% (close to our own projections, as provided in Section 3), respectively, from 3.0% and 3.8%. While the Q3 GDP outturn marked the slowest growth since the fourth quarter of 2009, there is some room for cautious optimism that growth has bottomed as consumption and exports picked up from the previous quarter. Singapore, on the other hand, has witnessed an even sharper slowdown, with Q3 preliminary output contracting at a seasonally adjusted annualized rate of -1.5% y/y, although a technical recession, as many analysts had feared, was narrowly avoided thanks to an upward revision of Q2 GDP growth to +0.2% y/y saar (from -1.1% y/y originally). The driver was lower exports, with non-oil domestic exports (NODX) falling by -3.4% y/y in September, on weaker European demand (-15.7% y/y), as has been the case for the rest of Asia.

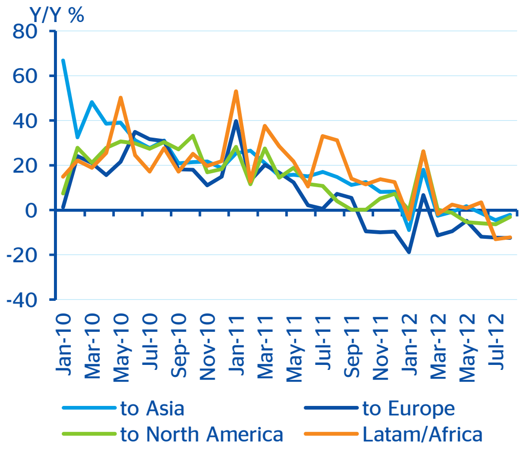
With the US recovery still sluggish and growth in emerging markets softening, a more recent concern is a broadening of export weakness to other markets, including the US, Latam, Africa, and even within Asia, which have all now become negative on an over-year basis (Chart 8). That said, exports to North America and the rest of Asia (intraregional trade) are holding up relatively better than exports to Europe. Indeed, as the share of exports to Europe has been declining, the share of intraregional trade has increased (Chart 9).

Chart 7
GDP growth continues to slow



Source: CEIC and BBVA Research

Chart 8
Weak European demand is accounting for a large share of the slowdown

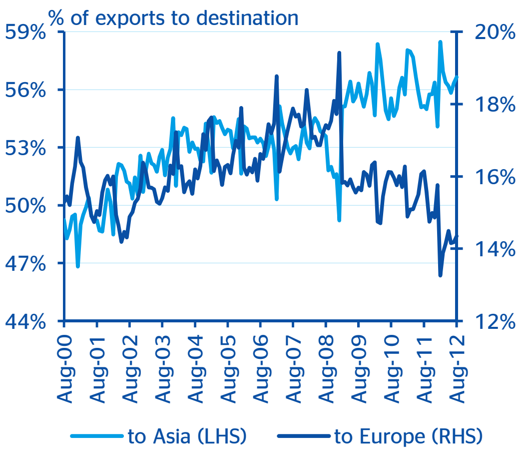


Source: CEIC and BBVA Research
*Data shown for HK, KO, SG, and TW

The impact of falling demand from the EU can also been seen in the supply chain through China (Chart 10). In particular, as exports from China to the EU have declined, Asian suppliers have, in turn, seen their exports to China decline as well given the high correlation between their shipments to China and China's overall exports (Chart 11).

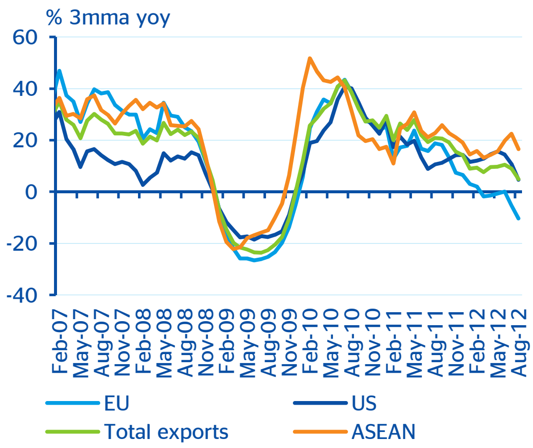
As the region's exports have slowed, business confidence has declined, although there are exceptions, such as in Thailand where the recovery from last year's floods has continued (Chart 12). At the same time, PMI's and growth rates of industrial production have declined relative to the same period a year ago (Chart 13). Japan, in particular, has seen a sharp fall in industrial production (-4.3% y/y in August), on headwinds from the global slowdown, the strong value of the yen, and more recently the diplomatic dispute with China.

Chart 9
Europe's share of exports has fallen as a result of the crisis



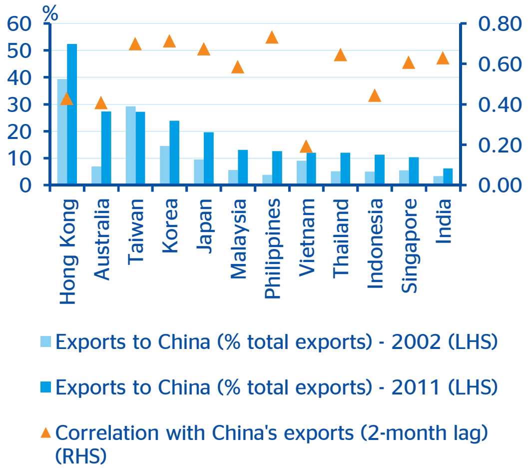
Source: CEIC and BBVA Research

Chart 10
The slowdown in China's exports is having a spillover effect on the region...



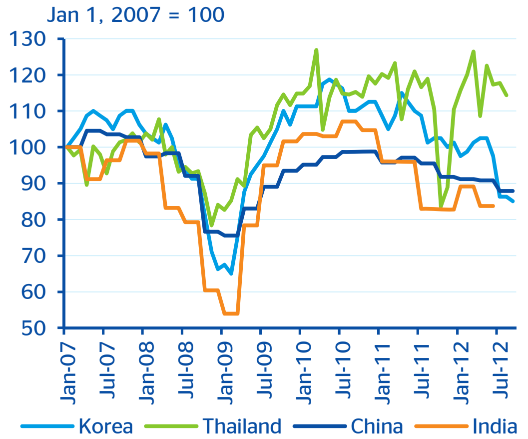
Source: CEIC and BBVA Research

Chart 11
...given the high correlation between China's and Asia's exports



Source: CEC and BBVA Research

Chart 12
Business confidence is weakening...

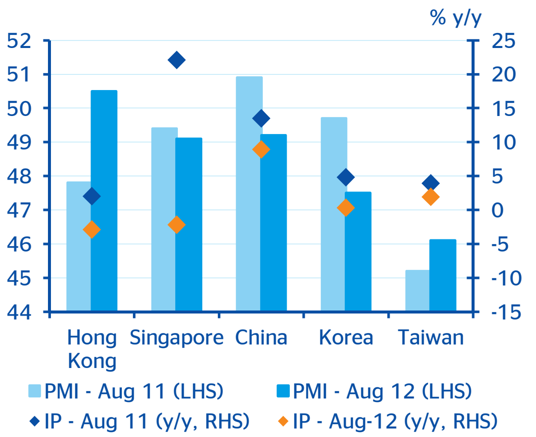


Source: CEIC and BBVA Research

Resilience in domestic demand has partially offset external weakness

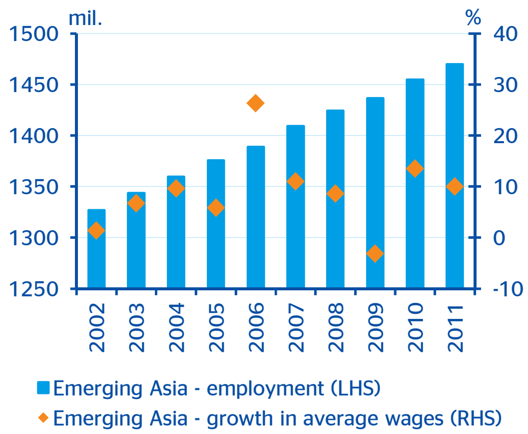
Resilient domestic demand, driven by still-tight labor markets and boosted by policy easing, remains a key support for regional growth. In particular, sustained employment and wage growth (Chart 14), strong credit growth (Chart 15), and lower interest rates have helped to offset some of the weakness in external demand. The strength of domestic demand has been most notable in the ASEAN economies (Chart 16), although the trend has been more mixed elsewhere in the region, with some weakening in Korea, Japan, and India (Chart 17 and 18), and subdued consumer confidence in some cases (Chart 19).

Chart 13
...and PMIs and IP growth have faltered since last year



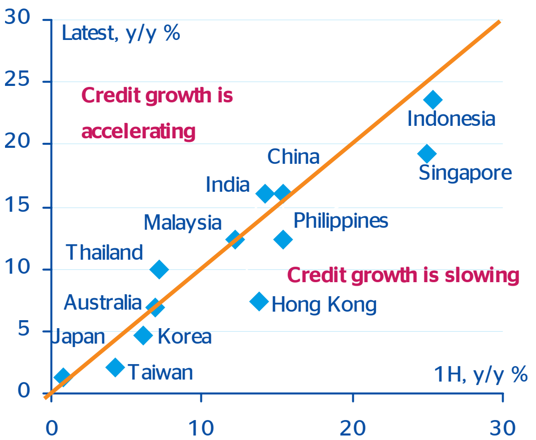
Source: CEIC and BBVA Research

Chart 14
Long-term employment gains and wage increases are supporting domestic demand



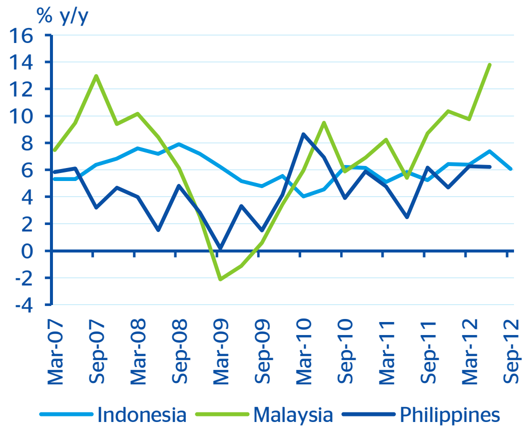
Source: CEIC and BBVA Research

Chart 15
Credit growth has remained supportive



Source: CEIC and BBVA Research

Chart 16
Final domestic demand* is strong in SE Asia…

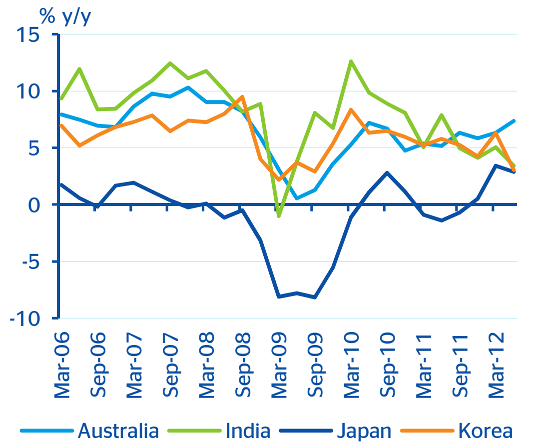


Source: CEIC and BBVA Research
*final domestic demand is consumption plus investment

Capital inflows are also helping to support domestic demand

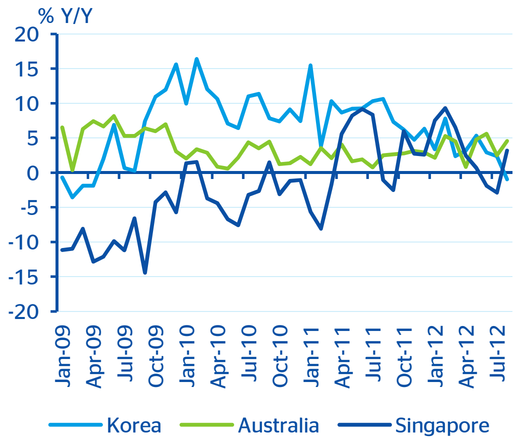
Strong global liquidity – reinforced by central bank actions in the US, EU, and Japan – are resulting in renewed capital inflows to the region. In this regard, foreign direct investment flows have risen in Korea, reaching a new record through the first nine months of the year to US$11.2bn, up by almost 50% from the same period in 2011. Indonesia has also seen strong FDI inflows, which surged to US$5.9bn in the third quarter.

Chart 17
…though it has been more mixed elsewhere



Source: CEIC and BBVA Research

Chart 18
Retail sales are faltering



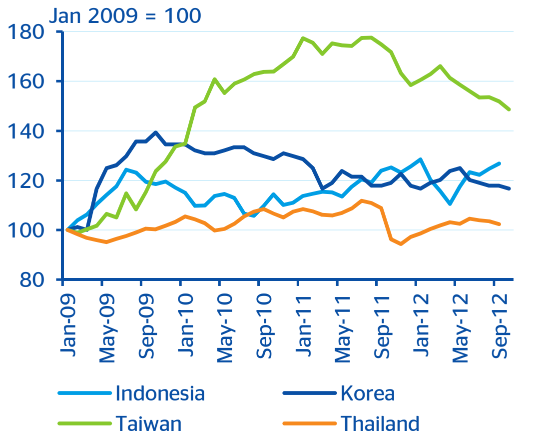
Source: CEIC and BBVA Research

Living in a post-QE3 world – Asia's reaction

The Fed's announcement in mid-September to launch QE3 was met with mixed reactions amongst Asian policymakers. On the one hand, with growth slowing and inflation remaining subdued – in contrast to the period when QE2 was launched -- QE3 was viewed as a welcome development (for details on its potential impact, see our recent EAGLEs *Economic Watch*).

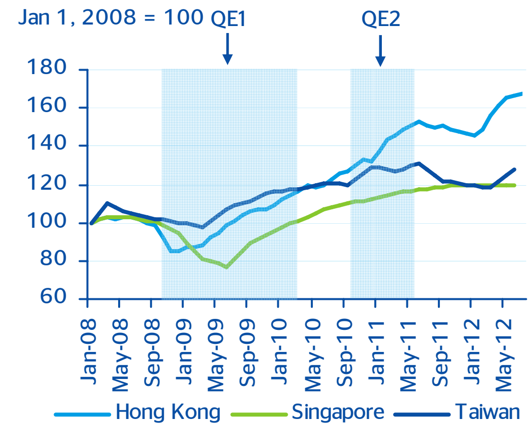
However, in economies such as Hong Kong and Singapore, where fears of liquidity-driven asset price bubbles persist (Chart 20), the reaction was more critical. Indeed, with property prices reaching record highs, Singapore and Hong Kong each announced new measures to curb further increases, including a cap on all new housing loans to 35 years from no cap previously in the former, and a new stamp duty on non-permanent resident purchases in the latter. In Thailand, the authorities responded by easing overseas investment rules in order to facilitate capital outflows. Elsewhere in the region, concerns were expressed about the impact on commodity prices (e.g. India) and the potential for destabilizing hot money flows (e.g., the Philippines).

Chart 19
Muted consumer confidence clouds the outlook



Source: CEIC and BBVA Research

Chart 20
Prior quantitative easing by the Fed clearly shows the impact on property prices in Asia



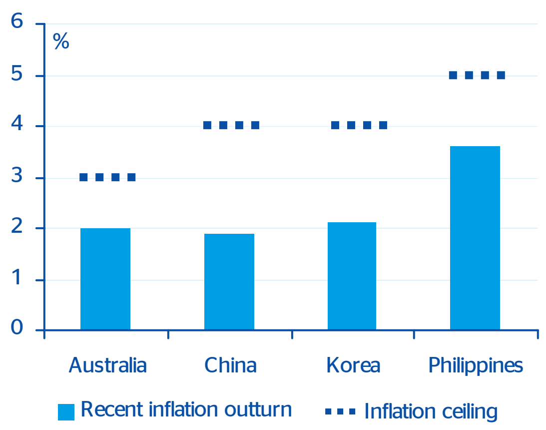
Source: CEIC and BBVA Research

Inflation remains subdued on weaker growth

With only a few exceptions (namely, India and Singapore), inflation remains well within comfort ranges (Chart 21) on weaker demand pressures and stable commodity prices. Core inflation also remains well contained. In the third quarter, for example, China (1.8% y/y in July) and Korea (1.2% y/y in August) posted their lowest year-on-year inflation rates in over two years, against inflation upper bound inflation targets of 4%, although there was a minor pickup in September to around 2% in both economies – still well within their comfort zones. In Taiwan, a sharp increase in August (to 3.4% y/y from 2.5% y/y the previous month) was largely due to temporary supply disturbances from a typhoon – inflation has since declined back to 2.4% y/y in October. Meanwhile, at the other end of the spectrum, deflation continued in Japan for a fourth consecutive month (-0.3% y/y in September), despite the Bank of Japan's adoption in February of a 1% inflation target and a recent step-up in the central bank's asset purchase program.

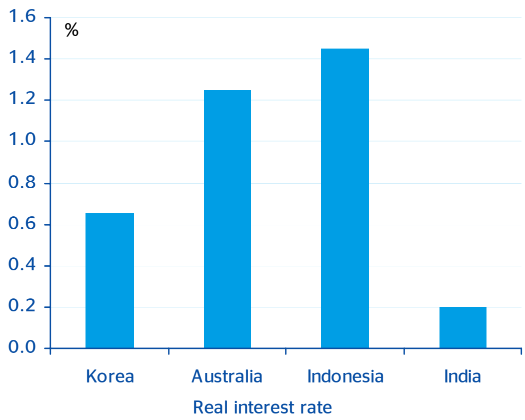
Inflation is still a concern in Singapore (4.7% y/y in September, up from 3.9% y/y in August) on rising housing and transportation costs, and in India, where the headline WPI has been sticky (up to 7.8% y/y from 7.6% in August, on the effects of a 12% hike in diesel prices). Inflationary pressures are also an issue in economies that have been witnessing robust growth, including Indonesia (above 4% since April), and in the Philippines, where inflation has risen in recent months from a low of 2.6% y/y in March to its current 3.1% y/y.

Chart 21
Inflation remains well within targets...



Source: CEIC and BBVA Research

Chart 22
...and real interest rates remain positive



Source: CEIC and BBVA Research

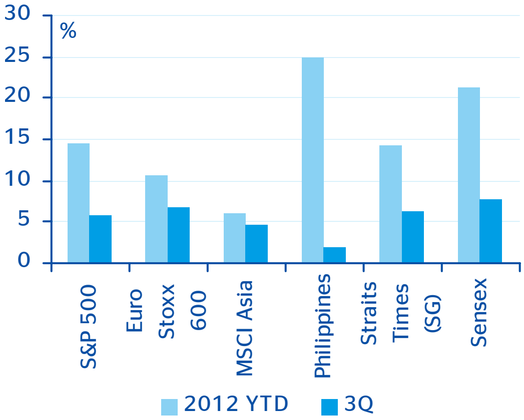
Monetary stances are growth supportive, with fiscal policy in reserve

For the most part, policymakers have been conservative in using their room for policy stimulus to counter external headwinds. This reflects a combination of factors, including the fact that, despite the slowdown, output gaps remain negligible and labor markets are still tight, and there is a preference to maintain room for easing in the event of a further deterioration in the external environment.

Monetary policy, rather than fiscal, has been the primary tool of choice in most Asian economies to buffer the headwinds from weaker external demand, as real interest rates largely remain positive (Chart 22). After standing pat for a long period, the Bank of Korea finally commenced rate cuts, totaling 50bps so far (25bps in July and again in October), bringing its policy rate to 2.75% - still positive in real terms, and some 75bps above the low point reached during the global financial crisis in 2009. Rate cuts have also been recently implemented in the Philippines, Thailand, and Australia. With interest rates already near zero, Japan, as noted above, has continued to expand its asset purchase program, to 91 trillion yen. The Monetary Authority of Singapore has been an outlier in the region as it maintained the appreciation path for its currency at its semi-annual policy meeting in October (the MAS uses the currency as its monetary policy mechanism, rather than interest rates) despite a sharp slowdown in growth.

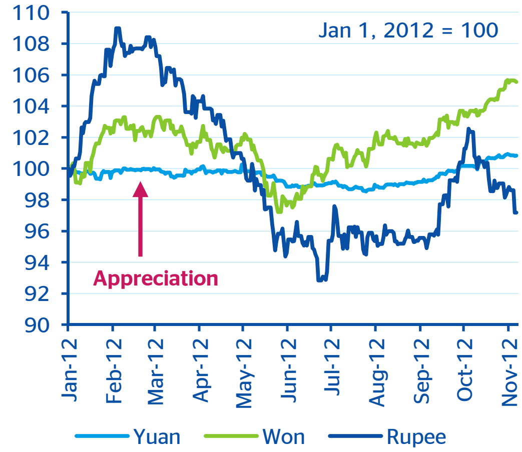
On the fiscal side, policy stances remain largely supportive, but a number of regional governments have preferred to keep tight reins on an expansion in their deficits, as they seek to return to budget neutrality after the stimulus measures put in place during the 2009 crisis. Australia, for example, plans to return to surplus in 2012-13 after running deficits for the previous four years. That said, there have been selective forms of support, for example in Korea, which unveiled measures in July and September to support small businesses and consumer spending. Meanwhile, Japan's government approved a larger-than-expected, although still modest, fiscal stimulus package of subsidies and grants worth 0.1% of GDP to help offset an expected economic contraction in the second half of this year. The package will be financed with funds in the budget reserve to avoid new debt issuance given Japan's extremely high public debt level. And, importantly, China has implemented stepped up fiscal spending on infrastructure and an acceleration of social housing construction. With the notable exceptions of India and Japan, most of the region has room for further fiscal stimulus as a safeguard against a deterioration in the external environment.

Chart 23
Asian equities rebounded in the third quarter; regional equity markets have outperformed



Source: Bloomberg and BBVA Research

Chart 24
The INR has rebounded off historic lows; KRW has appreciated on strong fundamentals



Source: Bloomberg and BBVA Research

Asian markets: regional equity indices have performed well

Equity markets have ebbed and flowed with global risk aversion, but since late summer have generally rallied on good news/data from Europe, US, and more recently in China. The Fed's announcement of 'unlimited' QE3 has resulted in a surge in global liquidity that is generating capital inflows. Favorable price/earnings ratios are also cause for optimism regarding regional equity markets, given the above positive factors. While the MSCI Asia index has trailed its peers in developed markets (Chart 23), regional equity markets have been clear outperformers in 2012, largely because China and Japan's weightings in the MSCI index is much greater than other countries (China and Japan have seen less gains this year than elsewhere in the region). The strongest advances so far this year have been seen in the Philippines (24.9%), Singapore (14.3%), and India (21.4%). However, despite a weak market environment as seen by tepid demand for IPOs and low volumes on major exchanges, Asian markets are broadly up (MSCI Asia +8.4%).

The performance of India is of particular note. As a result of improved investor confidence, especially following the Indian government's announcement of policy reforms in September (the authorities announced several new steps to encourage capital inflows), the rupee appreciated by 5.4% from late June to early October, although it has since retraced much of those gains because of equity outflows and concerns over central bank policy. Despite the recent weakness, the rupee remains higher now than back in June, when a sharp depreciation of the currency caused it to reach a historic low (between March 1st and June 22, the currency depreciated by 16.1%). The Sensex has also notably risen this year - posting one of the highest returns in the region (20.8%) - as the aforementioned policy adjustments are improving the corporate outlook.

Currencies have performed well on balance (Chart 24), especially after the ECB's policy announcement of bond purchases and the Fed's QE3. The Philippines peso reached a four-year high in September, while the Korean won touched a 13-month high at the end of October. The Singapore dollar has persistently traded near the strong end of the band as the Monetary Authority of Singapore decided not to slow the pace of appreciation at its October review meeting. Meanwhile, the Hong Kong Monetary Authority has been forced to intervene for the first time in nearly three years to weaken its currency after it reached the top of its trading band versus the dollar (7.75/USD) as capital inflows surged. A sudden spurt in appreciation of the Chinese currency in September/October, due to both capital inflows and, quite possibility, efforts by the authorities to ease trade tensions ahead of the US Presidential election, may have contributed to the broader regional appreciation trend.

The Japanese yen has weakened from its previous highs. This is due to a number of factors, including periodic threats of intervention, the BoJ's quantitative easing, persistent trade deficits, and improved global risk appetite (given the yen's safe haven characteristics, the currency tends to strengthen during bouts of high risk aversion). As such, the yen has recently weakened closer to 80 per USD, after averaging around 78.5/USD during the third quarter. In addition, despite positive economic momentum, the Indonesian rupiah has depreciated this year as slowing exports and strong imports have resulted in ongoing current account deficits. The Indonesian authorities responded by using foreign reserves to smooth daily volatility, causing reserves to decline by almost US$10bn from April to July. Since then, reserves have rebounded to US$102.6bn.

Box 1. The economic fallout of the China-Japan dispute

Bilateral relations between China and Japan have deteriorated sharply in recent months over a territorial dispute involving the Diaoyu/Senkaku islands in the East China Sea. Beyond the political ramifications, the dispute puts economic ties between China and Japan – the world's second and third largest economies, respectively – at risk. In particular, the dispute could undermine trade, investment flows, and tourism between the two economies. Japan's GDP growth could be affected adversely given the size of the Chinese market for its exports and inflows of tourism; the direct impact on China, in contrast, would be much smaller.

Economic co-dependency

Bilateral trade between China and Japan amounted to $310 billion in 2011, consisting of $150 billion in Chinese exports to Japan, and $160 billion of Japanese exports to China. China is Japan's largest export market (18% of total exports through the first 9 months of 2012, equivalent to 2.4% of GDP), while Japan is China's fourth largest market (8% of total exports, worth 2.2% of GDP), after the EU, US and Hong Kong. Notably, China's market has been growing in importance for Japan, while the reverse is true of Japan's market for China (Chart 25).

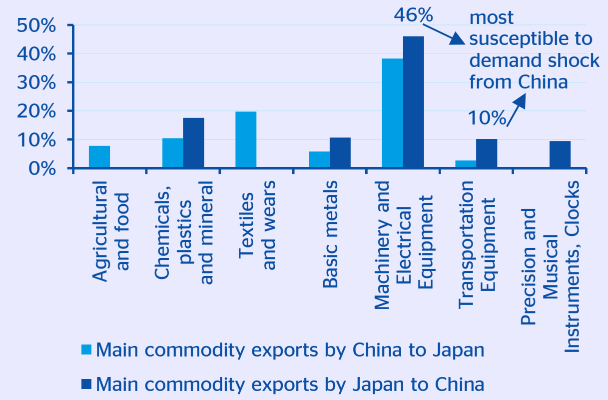
Chart 25
Exports shares between China and Japan

Source: CEIC and BBVA Research

Japan's exports to China consist of relatively high value-added products (machinery and electrical equipment, and transportation equipment together account for 56% of total exports), while China's exports to Japan are of lower value added (Chart 26).

Japan is the third largest foreign direct investor in China (after Hong Kong and the EU), accounting for 5.3% (US$26.5bn) of China's FDI inflows during 2006-2010. On the other hand, China's investment in Japan is relatively small (around US$350mn).

Chart 26
Exports between China and Japan by product



Source: CEIC and BBVA Research

While both countries are major tourism markets for each other, the share of Chinese visitors to Japan exceeds the share of Japan's visitors to China (18% vs 2.6%). A disruption of such flows, therefore, could have a relatively severe impact on Japan's tourism industry, which has been benefiting from increased inflows from China – Chinese visitors to Japan expanded by 15% per year during 2000-2010. For the year 2010 Japan's tourism inflows amounted to 0.2% of GDP.

Economic impact of the dispute

Despite the limited availability of data so far, some impact of the dispute is already evident. Japanese companies operating in China, especially in the auto sector, have been affected by the boycotting of Japanese brands, with such sales down by 40-50% y/y in September and October. The growth of Chinese tourism receipts in Japan decelerated to 10% y/y in September from 89% y/y in August, and Japan's exports to China declined by -14% y/y in September (compared to an increase of 4% y/y in imports from non-Japan markets). Going forward, if the dispute were to continue having an effect of a similar magnitude over the coming year (resulting in a 10% decline in Japanese exports to China relative to our baseline), the impact on Japanese growth could amount to at least 0.3% of GDP according to our estimates. The impact on China through reduced exports and tourism receipts would be much smaller; however, there could be a longer term loss of output and employment due to lower FDI inflows from Japan.

3. Growth momentum is gradually improving

Consistent with our previous *Asia Outlook* published last August, our baseline continues to build in a gradual pickup during the remainder of the year and into 2013 on the effects of ongoing policy support and improving global conditions. As a result, in all but a handful of countries (such as Japan and Australia) we are forecasting better growth in 2013 (Table 1). Nevertheless, the growth outlook is dominated by downside risks due to global uncertainties and rising geopolitical tensions within the region. While price pressures may increase with a pickup in growth, as envisaged under the baseline, our outlook for inflation remains generally subdued, which should provide scope for further policy easing if needed to sustain growth.

Downward revisions to 2012 and 2013 GDP forecasts

We have revised our 2012 and 2013 projections modestly downwards, due mainly to weaker outturns through the third quarter of 2012. As such, our growth projections for the Asia Pacific region now stand at 5.2% y/y and 5.5% y/y, respectively, down from 5.4%% y/y and 5.8% y/y previously. For 2012, the largest downward revisions are to Hong Kong (to 1.3% y/y from 2.1% y/y previously), Singapore (to 2.1% y/y from 2.6% y/y), and Taiwan (to 1.2% y/y from 2.0% y/y) due to sluggish exports. We are also revising Japan's growth downward slightly for this year (to 2.2% from 2.4%), as post-earthquake reconstruction winds down and on signs of slowing domestic and external demand (the latter being affected in part from rising tensions with China). And Korea's forecast is being revised down (to 2.3% y/y from 2.5% y/y) on spillovers to domestic demand from weak exports.

For 2013, our most significant downward revisions are for China (to 7.9% y/y from 8.3% y/y) and India (to 6.7% y/y from 7.1% y/y). The downward revision for China reflects weaker-than-expected growth momentum through the third quarter of the current year, and a less forceful policy response than previously expected. The projection assumes a bottoming out of growth momentum in Q3, with a modest pickup to 7.5% y/y in Q4 and into 2013. For India, we still expect growth to pickup in 2013, but not quite as strongly as previously expected due to lingering investor concerns about the durability of the renewed reform effort. We are raising our 2013 growth projections in the Philippines (to 5.0% y/y from 4.5% y/y) and Malaysia (to 5.0% y/y from 4.9% y/y). The Philippines appears well placed to grow at a healthy pace over the coming year as the economy attracts foreign investment inflows and will benefit from positive domestic policies.

Inflation: broadly keeping our forecasts, inflation to rise in 2013

We expect inflationary pressures to rise slightly in 2013 as growth picks up, but to remain broadly flat on average compared with this year (Table 2). The only significant revision is for India, where we expect inflation to average 7.8% y/y in 2012 and 6.7% y/y in 2013, up from 7.3% y/y and 6.3% y/y previously, on energy price adjustments, higher commodity prices and supply side issues. In China, we expect inflation to rise gradually in 2013, but to remain within the authorities' 4% comfort level. Meanwhile, in Indonesia, as previously projected, inflation is expected to rise in 2013 on the scaling back of subsidies, including on electricity, with upward risks arising from the rupiah's recent depreciation.

Room for policy support in 2013 if needed

Despite recent cuts in interest rates, policymakers have exercised caution in using their room for policy stimulus to counter external headwinds to growth. With inflation remaining low, there is still scope for further interest rate cuts, if needed, to sustain growth, especially in China, India, Korea, and Australia, although our baseline at present builds in cuts only in China (Table 4). In Korea, if growth remains weak there is a possibility of a rate cut after the Presidential elections in December. Similarly, the Reserve Bank of Australia has room to cut rates further if the non-mining sector does not pick up given that the mining sector boom is expected to peak during 2013-2014, and we expect further easing from the Bank of Japan in the form of gradual increases in the size of its asset purchase program. In contrast, we see little room for interest rate cuts in Indonesia due to strong growth momentum and rising inflationary risks.

For the next year, overall fiscal balances are expected to gradually improve, with the exceptions of Indonesia, Malaysia, and Thailand. That said, we would not be surprised to see stimulus measures in Korea, especially after the Presidential elections in December, and possibly in the Philippines. We continue to anticipate additional stimulus measures in China after its once-in-a-decade leadership transition is settled in November. Such measures would likely focus on stepped up infrastructure spending. In contrast, the scope for fiscal stimulus in India and Japan continues to be constrained by their high deficit and debt levels.

Asian currencies have risen sharply, risks to the downside

If global conditions improve, as expected under our baseline, a renewal of inflows should support further appreciation. In the very near term, the outlook is mixed, as some currencies like the Australian dollar may appreciate through the end of this year, while others, like the Japanese yen, may depreciate (Table 3). However, the appreciation of Asian currencies since July already looks stretched and may take a breather in the near-term given heightened concerns about how the US fiscal cliff will be resolved, the uncertainty over when Spain will make a formal aid request, policy paralysis in China in the midst of a leadership transition and the likely reversal of CNY appreciation following a US Treasury report publication in November. On the balance, however, if global conditions improve by early next year then we will likely see a renewal of inflows and further appreciation.

4. Downside risks remain

While risks to the external outlook have receded somewhat following recent policy initiatives in Europe, and further quantitative easing in the US, global uncertainties continue to pose the most significant downside risks to our outlook for Asia. In particular, in Europe the growth outlook remains weak, and investors are still uncertain about prospects for full policy implementation. In the US, while recent data point to continued (albeit sluggish) growth, the threat of a "fiscal cliff" will weigh on sentiment during the remainder of the year and, if not resolved on a timely basis, could have severe consequences for the growth outlook for 2013.

In the event that the Eurozone crisis persists, or even deepens, growth would be considerably lower in 2013 through a combination of weaker export growth and heightened risk aversion that would result in tighter financial conditions and weigh on investment. In such a scenario, and after taking into account the scope for policy stimulus, growth would be lower by around one percentage point on average, with the more open economies such as Hong Kong most severely affected.

We see two primary risks emanating from within the region. First is the possibility of weaker-than-expected growth in China. This risk has receded for the time being, given recent signs of stabilizing growth. Nevertheless, we are no longer as confident that a strong policy response would be forthcoming to arrest the growth slowdown, and the ongoing leadership transition has been less smooth than previously expected. Slower growth in China could pose risks for the region, especially for the numerous economies that rely heavily on China as an export destination. The second risk is posed by heightened tensions between China and its neighbors, especially Japan, over disputed territories. If not resolved, these disputes could undermine regional economic cooperation and integration, and could threaten intra-regional trade and investment flows.

There are a number of country-specific risks that also bear monitoring. In addition to the leadership transition in China, elections for Prime Minister are likely to be held soon in Japan, and a Presidential election is scheduled in Korea. In India, it will be important for policymakers to sustain the renewed reform momentum, or there is a risk of another dip in investor confidence that could reduce capital inflows and investment.

5. Tables

Table 1
Macroeconomic Forecasts: Gross Domestic Product

(YoY% growth rate)	2009	2010	2011	2012 (F)	2013 (F)
U.S.	-3.1	2.4	1.8	2.1	1.8
EMU	-4.4	1.9	1.5	-0.5	0.3
Asia-Pacific	4.2	8.1	5.8	5.2	5.5
Australia	1.5	2.4	2.2	3.2	3.0
Japan	-5.5	4.4	-0.7	2.2	1.2
China	9.2	10.4	9.2	7.6	7.9
Hong Kong	-2.7	7.0	5.0	1.3	3.0
India	9.1	8.8	7.5	5.6	6.7
Indonesia	4.6	6.1	6.5	6.2	6.3
Korea	0.3	6.2	3.6	2.3	2.9
Malaysia	-1.6	7.2	5.1	4.5	5.0
Philippines	1.1	7.6	3.9	5.5	5.0
Singapore	-0.8	14.5	5.0	2.1	2.5
Taiwan	-1.9	10.8	4.0	1.2	3.5
Thailand	-2.3	7.8	0.1	5.0	4.8
Vietnam	5.3	6.8	5.9	5.0	6.1
Asia ex China	1.0	6.7	3.5	3.7	3.9
World	-0.6	5.1	3.9	3.2	3.5

Source: CEIC and BBVA Research

Table 2
Macroeconomic Forecasts: Inflation (Avg.)

(YoY% growth rate)	2009	2010	2011	2012 (F)	2013 (F)
U.S.	-0.4	1.6	3.1	2.0	2.1
EMU	0.3	1.6	2.7	2.5	1.8
Asia-Pacific	0.3	3.6	4.8	3.3	3.4
Australia	1.8	2.8	3.4	1.8	2.9
Japan	-1.4	-0.7	-0.3	0.1	0.1
China	-0.8	3.3	5.4	3.0	3.6
Hong Kong	0.6	2.3	5.3	3.9	3.7
India	2.4	9.6	9.4	7.8	6.7
Indonesia	4.8	5.1	5.4	4.6	5.1
Korea	2.8	3.0	4.0	2.2	2.9
Malaysia	0.6	1.7	3.2	1.8	2.9
Philippines	3.2	3.8	4.4	3.4	3.9
Singapore	0.6	2.8	5.2	4.4	3.4
Taiwan	-0.9	1.0	1.4	1.9	1.8
Thailand	-0.8	3.3	3.8	3.1	3.3
Vietnam	6.9	10.0	18.1	9.4	8.4
Asia ex China	1.0	3.7	4.3	3.4	3.3
World	2.2	3.0	5.1	4.2	4.0

Source: CEIC and BBVA Research

Table 3
Macroeconomic Forecasts: Exchange Rates (End of period)

		2009	2010	2011	2012 (F)	2013 (F)
EMU	USD/EUR	1.43	1.34	1.30	1.28	1.30
Australia	USD/AUD	0.90	1.02	1.02	1.06	1.08
Japan	JPY/USD	92.1	81.1	76.9	82.0	86.0
China	CNY/USD	6.83	6.61	6.30	6.32	6.13
Hong Kong	HKD/USD	7.75	7.77	7.77	7.80	7.80
India	INR/USD	46.60	44.71	53.06	53.5	51.0
Indonesia	IDR/USD	9395	8996	9069	9400	9000
Korea	KRW/USD	1166	1126	1152	1120	1100
Malaysia	MYR/USD	3.52	3.06	3.17	3.05	2.90
Philippines	PHP/USD	46.8	43.8	43.80	42.00	41.50
Singapore	SGD/USD	1.40	1.28	1.30	1.22	1.20
Taiwan	NTD/USD	32.3	29.3	30.28	30.00	29.70
Thailand	THB/USD	33.3	30.1	31.55	30.50	30.50
Vietnam	VND/USD	17942	19498	21034	21500	22000

Source: CEIC and BBVA Research

Table 4
Macroeconomic Forecasts: Policy Rates (End of period)

(%)	Current	2010	2011	2012 (F)	2013 (F)
U.S.	0.25	0.25	0.25	0.25	0.25
EMU	0.75	1.00	1.00	0.75	0.75
Australia	3.50	4.75	4.25	3.25	3.50
Japan	0.10	0.10	0.10	0.10	0.10
China	6.00	5.81	6.56	5.75	5.75
Hong Kong	0.50	0.50	0.50	0.50	0.50
India	8.00	6.25	8.50	8.00	6.75
Indonesia	5.75	6.50	6.00	5.75	5.75
Korea	3.00	2.50	3.25	2.75	2.75
Malaysia	3.00	2.75	3.00	3.00	3.00
Philippines	3.75	4.00	4.50	3.50	3.50
Singapore	0.40	0.48	0.45	0.40	0.40
Taiwan	1.88	1.63	1.88	1.88	1.88
Thailand	3.00	2.00	3.25	2.50	3.00
Vietnam	9.00	9.00	9.00	9.00	9.00

Source: CEIC and BBVA Research

DISCLAIMER

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