BBVA | RESEARCH

Economic Outlook

Asia

First quarter 2013
Economic Analysis

- **The global economic outlook is improving** due to reduced tail risks in Europe, the avoidance of the "fiscal cliff" in the US, and the resilience of emerging economies, especially China. We expect global growth to rise from 3.2% in 2012 to 3.6% in 2013.

- **After bottoming out in Q3 of 2012, growth momentum in Asia has begun to pick up.** The pickup is due to accommodative domestic policies, strong domestic demand, and positive spillovers from rising growth in China.

- **We expect the gradual pickup to continue in 2013, broadly in line with previous projections.** Inflation is expected to rise, but should stay manageable. Expected capital inflows and their associated currency appreciation pressures will pose policy challenges during the year.

- **Risks have become more evenly balanced.** Though downside risks remain sizeable due to global uncertainties, upside surprises are also possible from stronger growth in China. Overheating in some of the ASEAN economies may pose a risk later in the year.

Index

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Summary

Asia's growth momentum has been picking up, as expected, on the strength of accommodative domestic policies and a rebound in China. After bottoming out in Q3, growth in most of the region's economies picked up in Q4 and recent high frequency indicators suggest the momentum is continuing into 2013. Labor markets remain tight, and domestic demand has been resilient, especially in the ASEAN economies. That said, the pickup has been quite modest and there remain pockets of weakness throughout the region, especially in some of the more open economies such as Singapore, Korea, and Australia.

Our growth forecasts continue to envisage a pickup for most economies in 2013-14 on continued policy support and an improving global environment. We expect growth for Asia-Pacific of 5.6% in 2013 (up from 5.2% in 2012), rising to 5.8% in 2014, underpinned by robust growth of around 8.0% in China for both years. Our main upward revision is for Japan in 2013 (1.7% from 1.2% previously) on stimulus measures of the new government and the Bank of Japan. In contrast, we have lowered our projection for India (6.5% from 6.7% previously) on weaker momentum and tighter monetary policy than expected.

Inflation has evolved as previously envisaged, and price pressures remain subdued. With the expected pickup in growth, inflation should rise gradually in 2013 but should remain manageable, providing room for policies to remain accommodative in most cases. However, capital inflows stemming from strong global liquidity and the region's robust growth prospects could exert upward pressures and generate asset price bubbles in some economies.

With inflationary pressures still at bay and the pickup in growth still modest, monetary policy continues to be on an easing bias in most countries. A number of central banks have eased policy in recent months, including Australia, India, Korea, Thailand, and Japan (quantitative easing). Looking ahead, we expect further easing in India, Korea, and Japan (through further expansion of the asset purchase program); and we would not rule out another rate cut in Australia if non-mining activity stays weak. Looking further ahead, rate hikes may be on the horizon in some ASEAN economies as overheating pressures mount (in this regard, Indonesia's widening current account deficit has drawn attention).

With growth momentum on the rise, fiscal policies in most economies are likely to be less expansionary than in 2012. Exceptions include Korea, where the new administration of President Guen-Hye Park has front-loaded 2013 spending and has left open the door to further spending stimulus. Japan is also an exception, where the new government of Prime Minister Shinzo Abe has implemented a fiscal stimulus package despite market concerns about Japan's high public debt. Elsewhere in the region, policies remain geared to fiscal consolidation, especially in India where policy makers continue to grapple with a large deficit, and in Australia where the government is seeking to return the budget to surplus.

Capital inflows and currency tensions will pose challenges to macro policy in 2013. We expect capital inflows to pick up due to global liquidity, reduced risk aversion, and the region's strong growth prospects. This could put upward pressure on inflation and asset prices, posing a challenge to monetary policy. In addition, the recent weakening of the yen is generating tensions among trading partners, especially Korea, which could cause the authorities to resist appreciation pressures through intervention and macroprudential tools.

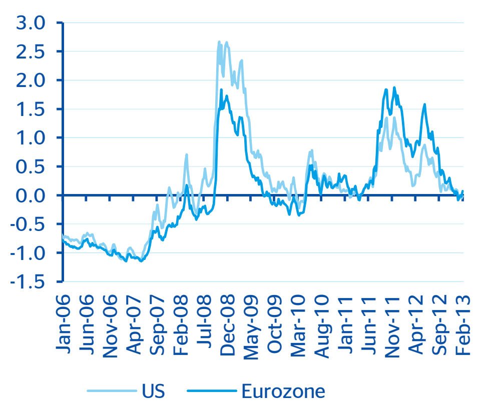
Though risks to the downside remain sizeable in view of global uncertainties, they have become more balanced than in previous quarters. Tail risks in Europe have diminished following positive policy steps, but the growth outlook has not yet improved, and smooth policy implementation cannot yet be taken for granted. In the US, policymakers are still grappling with key elements of the fiscal strategy. Within the region, geopolitical tensions remain elevated between China and Japan, and events in North Korea pose a perennial risk. On the other hand, growth outturns could exceed expectations if the global economy picks up faster than expected and if China's rebound surprises to the upside. Overheating risks may emerge in economies such as Indonesia and the Philippines before the end of 2013.

1. Improved sentiment and lower 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.

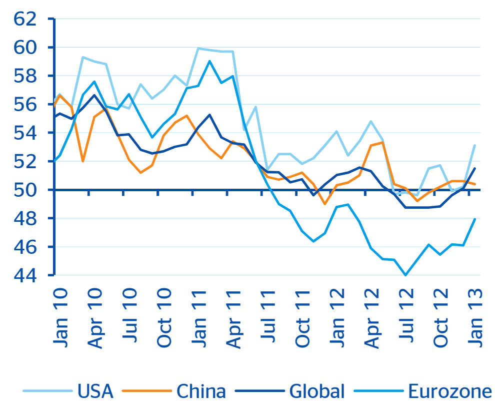
Over the past three months, a number of threats to the global economic outlook have faded, sparking a tide of renewed optimism. Financial tensions have decreased to two-year lows (Chart 1), particularly in Europe, and almost all asset classes have benefited. There has also been a boost to consumer and business confidence which has spread among regions (Chart 2). However, there has not yet been any significant change in economic activity. According to our estimates, global GDP in 2012 grew by 3.2%, down from 3.9% in 2011. Recent data suggest that global GDP may now be accelerating, albeit from low levels.

Chart 1
BBVA Financial Stress Index



Source: BBVA Research

Chart 2
Confidence Indicator (PMI)



Source: CEIC and BBVA Research

Advances in policy implementation lie behind improved confidence

China has averted a hard landing. Since the third quarter of 2012, GDP growth has accelerated. Investment has accounted for much of the rebound in GDP on the back of stimulus policies. Furthermore, tentative signs of improvement in exports have emerged, on demand from Asian countries and the US, though exports to Europe and Japan have remained a drag. In addition, the transfer of political power has been proceeding smoothly. However, there are still some concerns about the sustainability of China's growth. Local debt and the pace of shadow bank lending are probably the biggest financial threats to growth. Even in the short term those threats could be a constraint for the implementation of new stimulus measures, if needed.

The rebound of the Chinese economy has been hailed as an element of the global economy's resilience. Other export-oriented economies are benefiting, including in Latin America through improved commodity prices.

The US did not fall off the cliff. In spite of a decline in GDP in 4Q12 (-0.1% in annualized terms), the underlying picture is brighter. Consumption growth has remained quite stable over the past quarters, averaging only slightly below pre-crisis growth levels. At the same time, the housing sector has gained momentum.

The fiscal deal at the turn of the year was welcomed by markets. It avoids a larger drag on the economy and it helps improve US public-debt sustainability. However, the agreement did not deal with two potential sources of uncertainty. First, the expenditure sequester is still scheduled to take place at the beginning of March. If implemented, there would be an additional drag on the economy of around 0.8% of GDP. Second, there was no permanent agreement on the debt ceiling, although a later deal suspended this ceiling until mid-May. Hence, in the coming weeks more negotiations will take place to avoid a sharp economic contraction in 2013 and, at the same time, to contribute to fiscal sustainability. However, a grand bargain is unlikely as long as policymakers continue kicking the can and fail to reach a bipartisan compromise.

Europe has done its part. The deal on Greece has shown that Europe is committed to maintaining its eurozone membership. In addition, the banking-union process has advanced since the December EU summit. The process seems critical to breaking the vicious circle between government and banking finances, and also to stemming the tide of capital outflows besetting some countries in Europe's periphery. Agreements reached at the December EU summit were not as ambitious as had first been hinted, but are still quite positive since they include a clear calendar for implementing a single supervision mechanism and initial steps towards a single resolution mechanism.

Finally, the ECB's OMT program appears to be having long-lasting effects as a real backstop, preventing financial tensions from escalating, even if neither Spain nor Italy (the most likely candidates) have yet asked for its activation. That situation may continue because governments of core and peripheral countries lack incentives to undergo such a process. With Spain's bonds yielding 5 – 5.5% and Italy's at 4 – 4.5%, the financial situation of the sovereign can hardly be seen as unbearable, in particular considering the political costs of a bail out from the point of view of the politicians in charge.

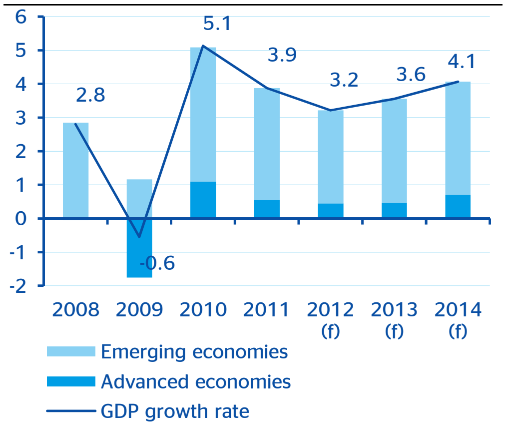
A soft recovery remains as our baseline scenario

Despite lower tail risks, improvements in economic fundamentals have been elusive. As a consequence, a soft recovery continues to be the most likely scenario for the global outlook. Even if the US has avoided falling off the fiscal cliff, US politicians still have to agree on key issues including the sequester and the debt ceiling, and fiscal policy in 2013 will turn tighter, squeezing household incomes. The real estate sector may be recovering, but the deleveraging process is still underway, and the external sector is far from buoyant. Therefore, we maintain the outlook for the US economy, although there is potential for positive surprises. In 2013 we expect the US economy to grow by 1.8% (down from 2.2% in 2012) and by 2.3% in 2014.

In the eurozone, tail risks may have disappeared, but the periphery remains mired in recession, dragged down by fiscal consolidation and funding conditions. Some economies still face deleveraging and fiscal austerity. However, leading indicators in Germany and other core countries are pointing to better prospects at the beginning of 2013. As a consequence, we roughly maintain our forecast for the eurozone of a rebound of a mere 0.3% in 2013 (after a contraction of 0.5% in 2012), and a 1.3% increase in 2014.

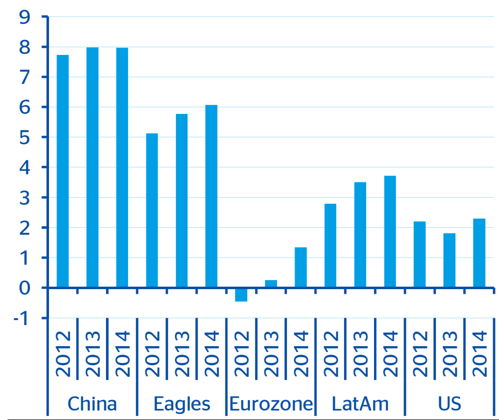
China is arguably the economy where the outlook has become clearer in the short term. We have revised our projections slightly upwards and now China is likely to grow by 8% in 2013 and 2014. The robustness of China's economy and the resilience of the US economy will play a role in supporting demand in most emerging countries. In Latin America as a whole, we have revised our forecasts slightly downwards, due to weaker situations in Brazil and Argentina. In 2013, the Latin American economies will grow by 3.5%, whereas in 2014 they will by 3.7%, approaching to their growth potential. In turn, emerging Asia will show a more robust growth, accelerating its pace to 6.6% in 2013, up from 6.1% in 2012.

Chart 3
World GDP Growth Rate



Source: CEIC and BBVA Research

Chart 4
GDP Growth rate (%)



Source: CEIC and BBVA Research

Uncertainty surrounding the global outlook remains high and tilted to the downside but, for the first time in three years, potential upside surprises are also present. The eurozone poses the biggest risk, and financial tensions may return for different reasons. The periphery of Europe could miss its current fiscal targets. If governments react with more austerity, the downturn may intensify. However, this risk is low because the European Commission has made clear that no further adjustment will be forced on these countries if targets are not met due to cyclical factors. At the same time, such an occurrence could roil markets and trigger bailout requests. In this regard, although the ECB seems ready to intervene, any potential wrangling between core and peripheral countries on conditionality could be a possible source of instability. Other factors may also play a role, like the details of the bank bailout for Cyprus, yet to be fixed, or political events such as the Italian elections. If financial tensions increased as a consequence of one or several of those triggers, the eurozone would continue in recession in 2013.

The other significant source of risk stems from the US political disagreement on how to deal with the fiscal deficit. According to our estimates, if both risks materialized the world economy would grow nearly a percentage point less than in the baseline scenario, well below its historical average. Adequate implementation of eurozone-governance agreements and further pacts on fiscal issues in the US are necessary conditions for a sustained global recovery.

2. Growth has bottomed out

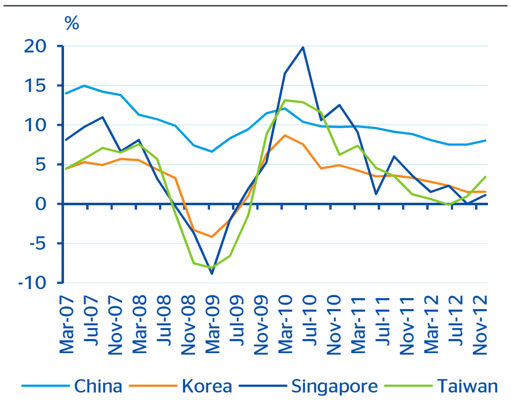
The anticipated upturn in Asian economies appears, at long last, to have occurred (Chart 5). While external demand from outside the region remains subdued (Chart 6), intraregional trade and domestic demand have been resilient, facilitating a modest pickup in growth momentum in the fourth quarter of 2012. In addition to improved global sentiment (see above), supportive domestic policy stances and an economic upturn in China have been key factors behind the pickup. Nevertheless, pockets of weakness persist, especially in the more export-oriented economies, as growth outturns have been below expectations in Japan, Korea, and Australia.

One of the most noteworthy regional developments over the past quarter has been the change in the leadership of Japan's government, when elections last December resulted in the victory of former Prime Minister Shinzo Abe. With growth weakening, the new Prime Minister took office with promises to reinvigorate the economy and end deflation. His actions have been controversial—not only domestically, but internationally in meetings of the G7 and G20 because of their currency implications—and include a fiscal stimulus package and pressure on the Bank of Japan to adopt a more aggressive easing stance and a higher inflation target (raised from 1% to 2%). As a result, and despite a third straight quarter of economic contraction in Q4, the stock market has surged and the yen has been on a steady weakening trend. The latter has already raised concerns among trading partners and could set the tone for contentious currency discussions in the months ahead (see Box on page 14 for details on Japan's economic policies), notwithstanding efforts by the G20 to avoid confrontation.

Beyond Japan, already accommodative fiscal and monetary policies have largely been on hold across the region. Recent exceptions on the monetary front are Australia, which cut rates in December (for a cumulative 175bps since November 2011) and India, which cut rates in January. On the fiscal front, other than Japan and Korea, most regional policymakers are seeking to rein in stimulus in order to keep debt levels low and save room for a rainy day.

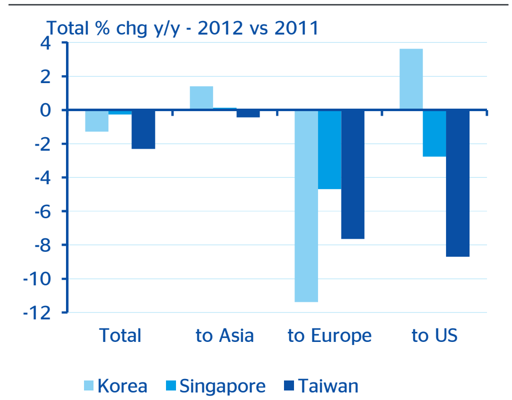
The region continues to be recognized by global investors for its sound fundamentals, setting the stage for further capital inflows in 2013. Ratings agencies have reaffirmed their robust assessments: in November Fitch affirmed Indonesia's investment grade rating (BBB-); Moody's affirmed India's 'stable' outlook for its Baa3 amidst concerns about slowing growth and "twin" current account and fiscal deficits, citing healthy savings and investment rates; S&P affirmed a stable outlook for China's AA- rating; and Moody's upgraded the Philippines to Ba1, citing healthy growth and the improved fiscal performance of the government. Even for Japan, where concerns persist about the high level of public debt amidst new fiscal stimulus measures, S&P has reaffirmed its AA- rating.

Chart 5
Asian GDP growth bottomed out in Q3 2012



Source: CEIC and BBVA Research

Chart 6
Asia's exports were weak overall in 2012, primarily due to Europe and the US



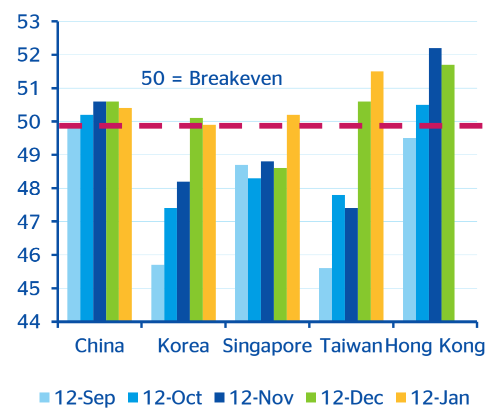
Source: CEIC and BBVA Research

Q4 growth outturns have exceeded expectations

GDP outturns in the fourth quarter confirm that the growth slowdown bottomed out in the third quarter (Chart 5). China's Q3 GDP grew by a better-than-expected 7.9% y/y (from 7.4% y/y in Q3), and while Korea's over-year outturn remained flat in the fourth quarter (1.5% y/y), its sequential growth momentum rose (to 0.4% q/q sa from 0.1% q/q sa the previous quarter). Taiwan's fourth quarter growth surprised to the upside at 3.4% y/y, from 1.0% y/y in Q3. Meanwhile, growth in South East Asia (ASEAN) continues to stand out, supported by robust domestic demand. The Philippines economy grew by 6.8% y/y in Q4 following 7.1% growth in Q3, Indonesia grew by 6.1% in Q4 following 6.2% in Q3, and robust growth in Thailand (18.9% y/y due to base effects from disruptions from last year's floods) resulted in full-year growth of 6.4%. Even Singapore, which has been posting sharply lower growth due to its high export dependency, expanded in Q4 (by 1.1% y/y) following a contraction in Q3, thereby avoiding a technical recession. The pickup in growth is supported by high frequency indicators, including PMIs and industrial production (Charts 7 and 8).

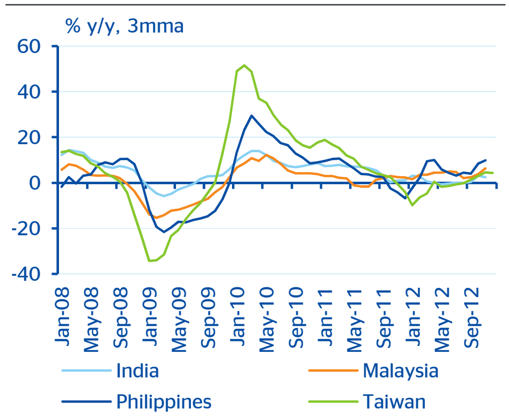
As noted in previous quarterly updates, Asian intraregional trade held up reasonably well in 2012 (Chart 6), due in large part to strong demand from ASEAN. The latter helped offset weak demand from Europe and the US. Export outturns in Korea and Taiwan are illustrative: 2012 exports to ASEAN (which account for 14% and 11% of total exports respectively) posted strong growth of 10.1% y/y and 9.8% y/y respectively. More generally, it appears export growth has begun picking up in a number of economies (Chart 9), though Japan's exports have been weak due to its island dispute with China (Chart 10).

Chart 7
Rising PMIs are a sign of improving growth prospects



Source: CEIC and BBVA Research

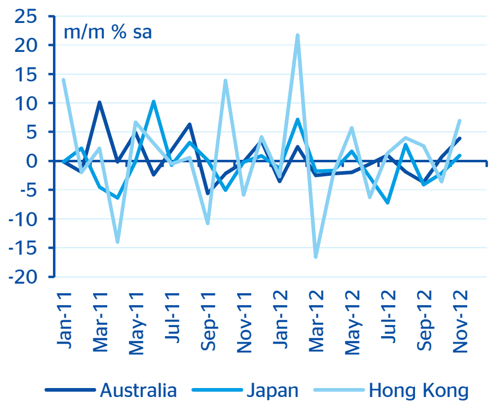
Chart 8
Regional IP growth is trending upwards



Source: CEIC and BBVA Research

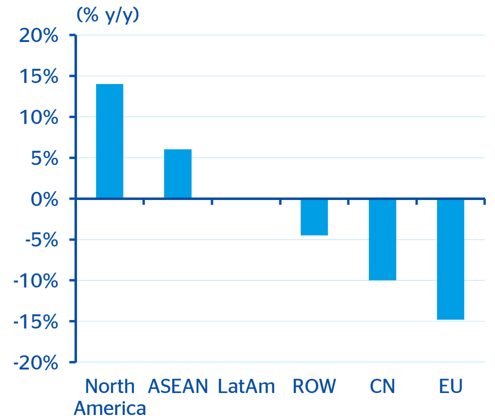
In addition to the positive trends in exports and PMIs, industrial production growth also appears to be gaining momentum (Chart 8). In India, where manufacturing has been under stress, growth of industrial production (IP) reached a 16-month high of 8.2% y/y in October; although IP growth has since lost steam, activity indicators have bottomed out. Similar pickups occurred in November in Malaysia (7.1%, followed by 3.7% in December) and the Philippines (9.8%), and in December in Taiwan (2.4%), influenced by Chinese demand.

Chart 9
Asian export growth shows signs of picking up



Source: CEIC and BBVA Research

Chart 10
Japan 2012 export growth by destination

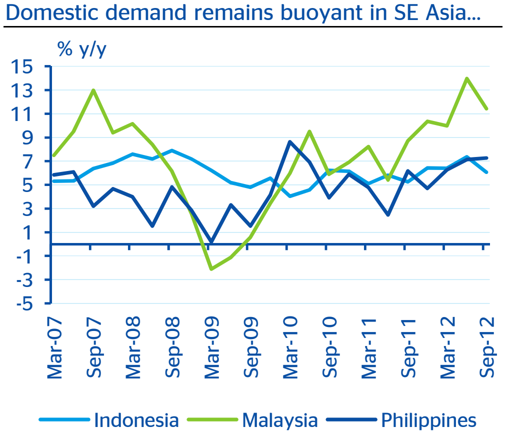


Source: CEIC and BBVA Research

Domestic demand and credit growth have shielded Asia from global headwinds

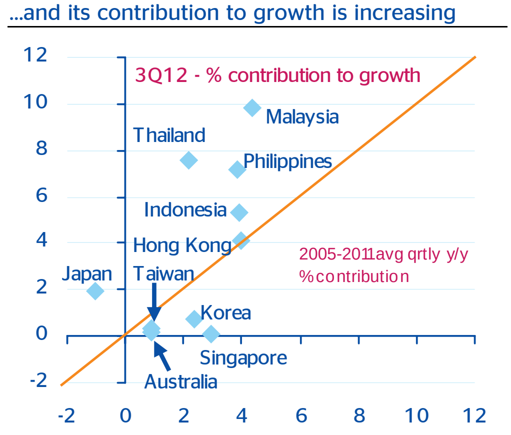
While the drop in exports has weighed on growth in the more open Asian economies, strong domestic demand has continued to support overall growth (Chart 11). This is especially visible in the ASEAN economies, where the contribution to growth in recent quarters exceeds historical averages by a large margin (Chart 12). Part of the increase is cyclical due to the combination of weak external demand and strong labor market conditions; at the same time, however, structural factors and economic rebalancing are at play, as rising urbanization (Chart 13) leads to higher per capita incomes and consumer spending. These trends are seen in strong retail sales (Chart 14), underpinned by robust auto demand (Indonesia). There have been exceptions, such as Korea, where December department store sales remained weak, although consumer confidence has picked up (Chart 15) since the Presidential elections.

Chart 11
Domestic demand remains buoyant in SE Asia...



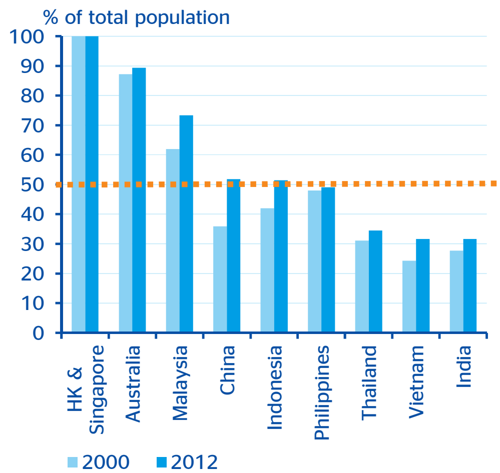
Source: CEIC and BBVA Research

Chart 12
...and its contribution to growth is increasing



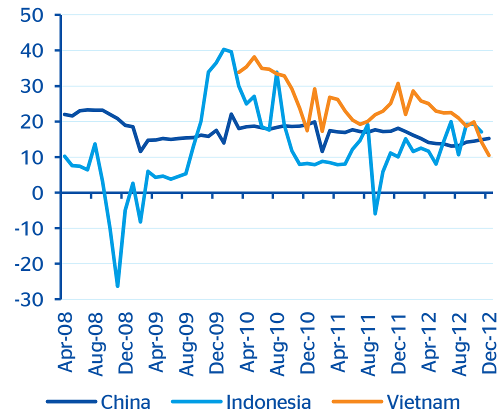
Source: CEIC and BBVA Research

Chart 13
Asia's urbanization trend is behind the surge in domestic demand



Source: CEIC and BBVA Research

Chart 14
Retail sales have remained relatively buoyant

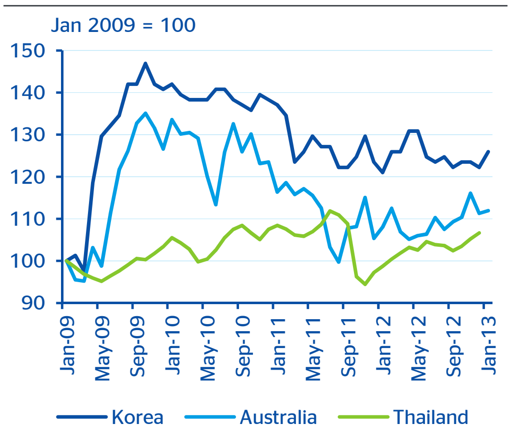


Source: CEIC and BBVA Research

Another factor supporting the resilience of domestic demand has been strong credit growth (Charts 16 and 17), which by some measures is becoming high relative to historical norms and could pose problems with asset quality and financial stability if left unchecked. That said, credit growth began cooling towards the end of 2012 (Chart 18).

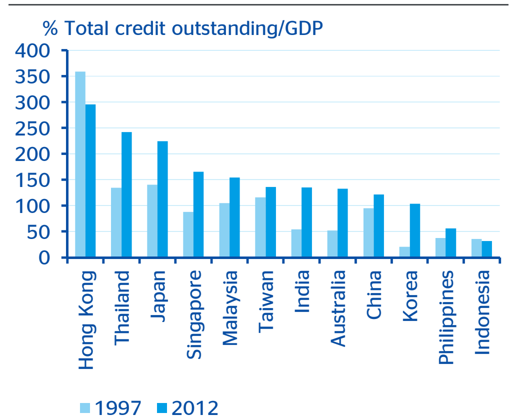
Rising property prices continue to make headlines, particularly in Hong Kong and Singapore (Chart 19). In the former, Hong Kong unveiled further tightening measures last October, including last October: i) a 15% Buyers' Stamp Duty (BSD) on home purchases by non-permanent residents; ii) extending the period of the Special Stamp Duty (SSD) tax to 3 years from 2 years; and ii) increasing the rate of the SSD (to 5% for 3 years; 10% for 2 years and 15% for 1 year). In Singapore, a new round of tightening measures was introduced in January, including an increase in its stamp duty and lower loan-to-value ratios.

Chart 15
Consumer confidence is picking up on an improved global environment



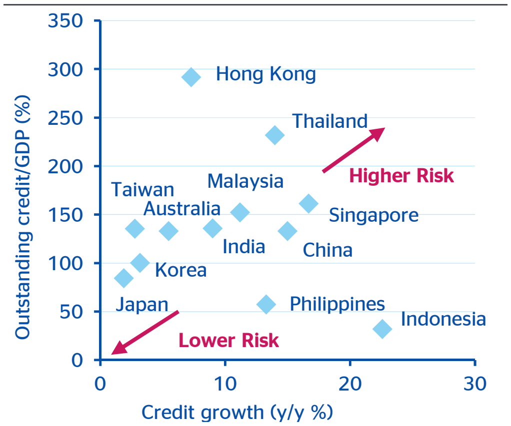
Source: CEIC and BBVA Research

Chart 16
Credit has grown rapidly since 1997



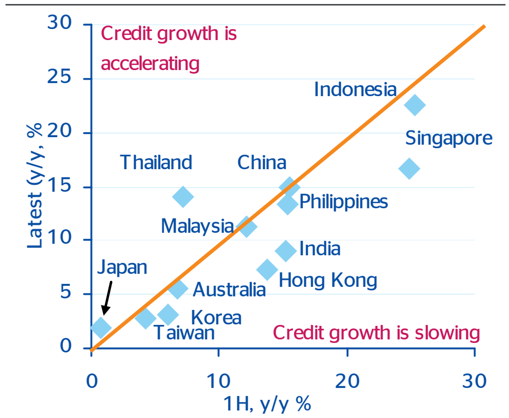
Source: CEIC and BBVA Research

Chart 17
Credit growth is a risk in some economies...



Source: CEIC and BBVA Research

Chart 18
...although it has shown signs of cooling following a rapid run-up in early 2012



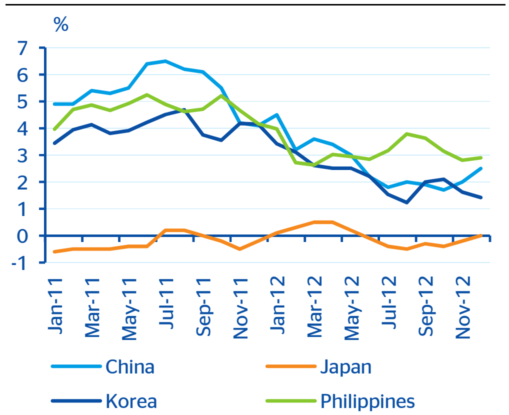
Source: CEIC and BBVA Research

Capital inflows have also played a role in supporting domestic demand, especially investment. In this regard, Indonesia's inward FDI (especially in mining and transportation) surged to a record US$23bn for the full year of 2012. Korea also reported record-high FDI of US$16.3bn in 2012, as investment from China more than doubled.

Chart 19
HK, SG property prices reach new historic highs

Source: CEIC and BBVA Research

Chart 20
Inflation remains low

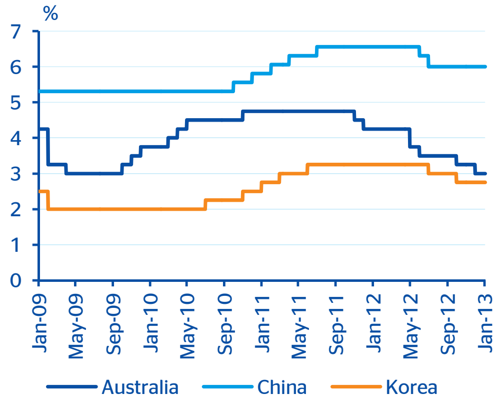


Source: CEIC and BBVA Research

Muted inflation has provided room for monetary easing

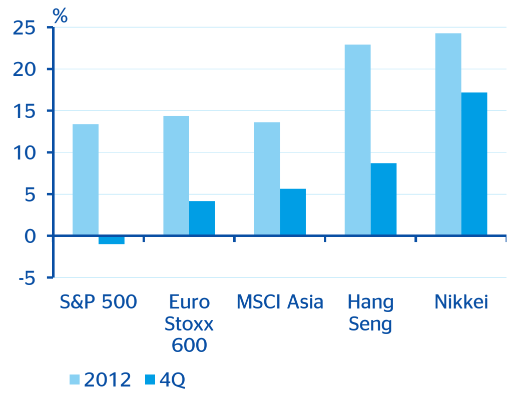
Continued output gaps and currency appreciation have helped keep inflation tame in most Asian economies (Chart 20). Inflation remains an ongoing concern in India, although it slipped to a three-year low in January of 6.8% y/y (WPI inflation) (see Box on India on page 16 for more details) Meanwhile, in Japan persistent deflation (-0.1% y/y in December) continues to plague the economy (for further details on Japan's policies, see Box on page 14).

Chart 21
Central banks adopted easing policies in 2012



Source: CEIC and BBVA Research

Chart 22
Regional markets outperformed in 4Q; Asia's broad index was broadly level with DM in 2012

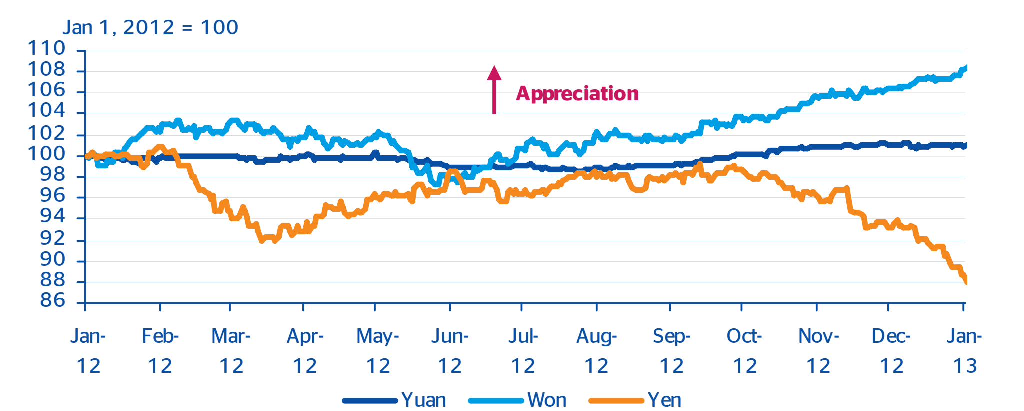


Source: CEIC and BBVA Research

With inflation running low, several central banks eased monetary policy further in the fourth quarter of 2012, including Australia (50bps), Korea (25bps), the Philippines (25bps), and Thailand (25bps). India recommenced its rate cutting cycle in January. The Bank of Japan continued to ease monetary policy through the expansion of its asset purchase program, and more recently announced a new inflation target of 2% (from 1% previously), to be reached 'as soon as possible,' along with an intention to begin larger-scale quantitative easing in January 2014. The Philippines, despite seeing a pickup in growth in the third quarter (to 7.1% y/y, from 5.9% y/y in Q2) cut interest rates to a record low of 3.5% in October to try to support its exporters and discourage capital inflows that were resulting in excessive currency strength.

Australia has now cut interest rates by a total of 175bps since November of 2011 (Chart 21), as the economy has been stuck in a 'two-speed' state whereby domestic demand has slowed while the mining/exports industry has been booming as a result of increasing demand from developing markets, particularly China. With it increasingly looking like the mining boom has peaked, Australia is seeking to support businesses through lower interest rates, as well as to counter currency strength that has largely occurred due to perceptions of its 'safe haven' status (Australia is rated AAA by all three major ratings agencies).

Chart 23
The yen's sharp fall was the major story in Q4



Source: Bloomberg and BBVA Research

Asian markets: strong performance in the fourth quarter

After turning in a strong performance in 2012, Asian equity markets have continued their rise in 2013 (Chart 22). China's emerging rebound has been an important element in boosting regional investor sentiment, and is the key factor behind the rise in Hong Kong's Hang Seng index. Among the ASEAN markets, the Philippines index stands out, having reached a new record high in early February. In addition to pricing in further strong economic growth, markets are poised for further ratings upgrades for the Philippines (all three major ratings agencies currently rate the Philippines one notch below investment grade). In Japan, equities began rising sharply in mid-November, after the (at the time) PM Noda announced fresh elections, on expectations of yen depreciation, which was seen as a positive for the country's exporters.

In currencies (Chart 23), the yen's sharp depreciation has sparked expectations of currency intervention, particularly in Korea (as well as the Philippines). The Korean won has appreciated by more than 20% against the yen since November, causing alarm among Korean exporters. In November and December, the Korean authorities sought to curb speculative pressures by cutting the forward position limit for foreign banks from 200% to 150% of capital, and from 40% to 30% for domestic banks. At the other end of the spectrum has been the Indonesian rupiah, emerging Asia's worst performer in 2012. Despite its strong status as an investment destination, a widening current account deficit and concerns about the momentum of economic reform (as in India) have weighed on the currency.

Box 1. Japan's new government seeks to jump-start the economy

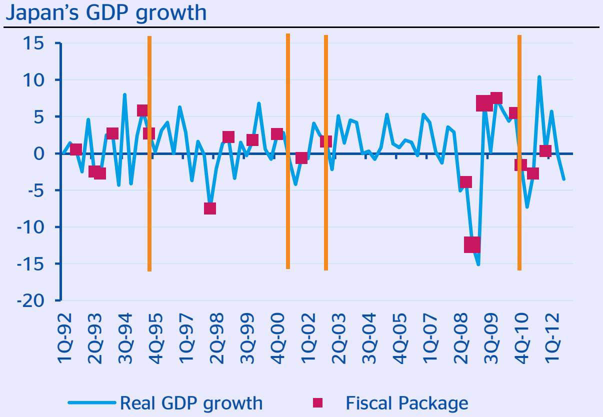
Japan's economy slowed sharply last year, with GDP contracting for three consecutive quarters, resulting in full-year growth of just 2.0% as both private consumption and exports slumping on weak external demand. At the same time, the dispute with China over the Diaoyu/ Senkaku Islands has been a further drag by adversely affecting trade and tourism flows.

LDP victory signals shift in policy

In December, the Liberal Democratic Party (LDP) won the general election, resulting in a significant shift in economic policy. The new Prime Minister, Shinzo Abe, has announced a package of fiscal and monetary policies to end persistent deflation and revive economic growth. On the fiscal front, despite Japan's high pubic debt level, the government has launched a ¥10.3tn stimulus package focusing primarily on public works. At the same time, in December the Bank of Japan expanded its asset purchasing program by around ¥3 trillion per month, and in January it announced a higher 2% inflation target, along with plans for open-ended asset purchases beginning in January 2014. The policies have already impacted the yen as well as market sentiment, with the exchange rate against the USD falling by 12% since December, and the stock market rising by more than 20%.

This is not the first time Japan government has attempted to stimulate the economy by using aggressive monetary and fiscal policies. Numerous measures have been used since 1990, the start of the so-called "lost decades."

Chart 24
Japan's GDP growth



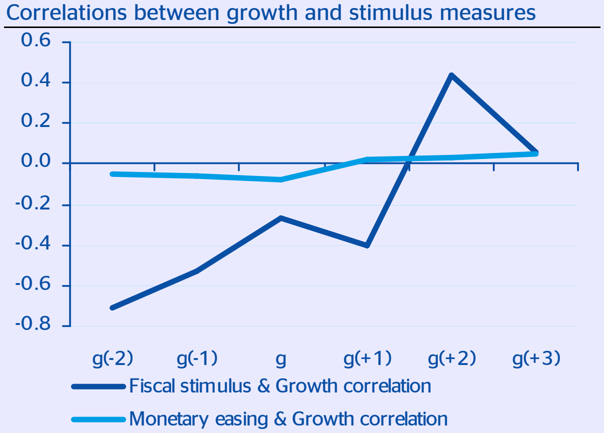
Note: vertical line indicates a period of monetary purchases
Source: CEIC and BBVA Research

In recent years, Japanese governments have introduced other large fiscal stimulus packages to address slowing growth (Chart 24). The largest two were implemented after the 2008 financial crisis with each exceeding 12% of GDP. These packages focused on two main components: investing in public works and social infrastructure projects, and credit guarantees and augmentation of credits lines to banks for loans to small and medium-sized enterprises and for the housing sector.

As far as the Bank of Japan, it previously lowered its key interest rate to virtually zero in early 1999, and resorted to unconventional easing measures of large scale asset purchasing after the IT bubble collapsed. The amount of Japanese government bonds and T-bills purchased were significantly increased again after the financial crisis. Despite these efforts, it is worth noting that they clearly failed to stop deflation, or weaken the yen (probably due to its safe haven characteristics).

Our estimates show the impact of Japan's fiscal measures is quite prominent, as seen by the correlation between the magnitude of the package and GDP growth rate (Chart 25), which we lag two quarters after the announcement date. Worth noting is that, perhaps contrary to expectations, monetary easing has a much smaller correlation with the growth rate.

Chart 25
Correlations between growth and stimulus measures



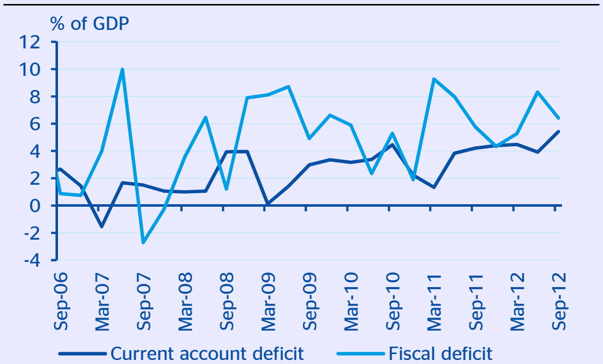
Source: CEIC and BBVA Research

Box 2. India – Time to reboot

It has been a difficult time for the Indian economy, as real GDP growth hit a decade low of 5.4% y/y (by 3Q12) and WPI inflation has remained elevated at around 7.0% y/y. A domestic policy logjam and ongoing external headwinds have dampened growth, while a loose fiscal policy (Chart 26) kept the Reserve Bank of India (RBI) from lowering interest rates in 2012, when other central banks were easing. These persistent fiscal slippages undermined efforts to narrow the current account deficit (a record 5.4% of GDP in 3Q12) and kept public debt (general government) relatively high at 70% of GDP. In this context, warnings from rating agencies of a possible downgrade to junk status heightened pressures on the Indian government to fast-track investment and fiscal reforms.

Reassuringly, over the last quarter the Indian government has announced several policy measures to stimulate slowing growth and avert a potential sovereign ratings downgrade. These initiatives include: 1) allowing foreign direct investment in multi-brand retail, civil aviation, broadcasting and electricity; 2) forming a Cabinet committee on investments to fast-track project approvals; 3) deferring regressive taxation rules on foreign inflows; 4) approving banking reforms, which aim to widen the scope for foreign bank entry in India, and facilitate financial inclusion, capital raising by banks and improvements in regulatory compliance. Furthermore, the Reserve Bank of India raised limits on foreign investment in the domestic bond market as well as on external commercial borrowings, and lowered the cash reserve ratio to ease foreign capital inflows and alleviate domestic liquidity pressures.

Chart 26
A tale of twin deficits



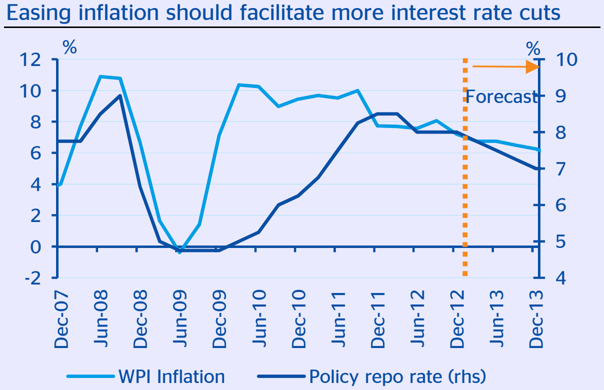
Source: CEIC and BBVA Research

Meanwhile, the authorities have also taken positive steps towards fiscal consolidation, such as 1) the partial deregulation of administered fuel prices, particularly diesel, 2) launching a direct cash transfer scheme to enhance efficiency of subsidies, transfers and social welfare payments, 3) building a consensus on implementation of a nationwide Goods and Services Tax (GST) to replace the existing VAT, and 4) reducing railway passenger subsidies.

Despite these positive steps, much more needs to be achieved in government. Slower GDP growth and weak corporate profitability has dragged on total receipts (up 14% y/y vs. 23% budgeted), while non-plan spending (includes interest and subsidies) has overshot the target (12% y/y vs. 9%). On current trends, we therefore project a modest overrun of the FY13 deficit, to reach 5.7% of GDP.

That said, the government's commitment to continue pushing reforms, despite political roadblocks, will help alleviate macro-stability risks, buying India time to avert a ratings downgrade as well as (eventually) improving investor sentiment. Looking ahead, with inflation trending lower (Chart 27) we anticipate an additional 75bps in repo rate cuts by the end of 2013, bringing the policy rate to 7.0%. We expect improvement in India's real GDP growth, averaging 6.5% y/y and 6.9% y/y in 2013 and 2014 respectively, led by a revival in private consumption and investment demand. Further traction in fiscal and investment reforms are a key for monetary policy to help boost growth without re-fuelling inflation risks. In this context, the upcoming Budget session of parliament, which begins on February 21st, is important, and will hopefully bring approval for the government's proposal for higher foreign direct investment in the insurance and pension sectors, as well as a leaner budget for FY14.

Chart 27
Easing inflation should facilitate more interest rate cuts



Source: CEIC and BBVA Research

3. Growth momentum should continue to improve

Consistent with our previous *Asia Outlook* published last November, our baseline builds in a further improvement in growth momentum in 2013. China's improving growth performance is already having positive spillovers in the rest of the region. Continued supportive monetary stances (especially, but not limited to Japan), along with a further gradual improvement in the global environment should sustain the ongoing pickup. As a result, in all but a handful of countries (Japan, Australia, and a few ASEAN economies that saw exceptionally high growth in 2012) we are forecasting better growth in 2013 (Table 1), and we expect growth to pick up further in 2014 for almost all economies. With the pickup in growth, inflation is expected to rise in most economies, but should remain within comfort levels, providing room to ease policy if needed as a guard against external risks.

Expect a pickup in growth momentum in 2013-14

We have left most of our growth forecasts for the region unchanged from our previous update last November. For Asia Pacific, we expect growth to pick up to 5.6% in 2013 (from 5.2% in 2012) and 5.8% 2014, underpinned by continued strong growth in China, of around 8.0% in 2013 and 2014. Our biggest revisions in 2013 are for Japan (to 1.7% from 1.2% previously) on the impact of the new government's stimulus measures, and for the Philippines (to 5.9% from 5.0% previously) on stronger domestic demand than envisaged previously. Our most significant downward revisions in 2013 are for India (6.5% from 6.7% previously) due to continued policy implementation logjams, and Korea (2.7% from 2.9%) on still-sluggish exports and domestic demand.

Inflation is expected to rise, but should stay manageable

It is highly likely that inflation has bottomed out, after having reached multi-year lows in Q3 and Q4 of 2012. Looking ahead we expect capital inflows to pickup, which should add to demand pressures from rising GDP growth. (Table 2). This is largely consistent with our previous forecasts and therefore on balance we have not made significant changes to our inflation outlook for either 2013 or 2014. We expect inflation to pick up in Indonesia in the coming months, and may rise towards the top end of authorities' comfort zone of 5.5%, especially if electricity tariffs are increased, as currently expected. Ongoing weakness in the rupiah may further exacerbate Indonesia's inflation.

Monetary policy outlook is heterogeneous, with fiscal on hold

After a round of interest rate cuts in 2012, we expect most central banks to remain on hold in the first half of 2013 (Table 4). However, we foresee further rate cuts in India (75bps) and Korea (25bps in the first half) and, while not yet in our baseline, we would not rule out another rate cut in Australia given low inflation and weakness in the non-mining sector. At the other end of the spectrum, we have removed our previously expected rate cut in China on signs that the economy is picking up and given concerns about rising housing prices. And in ASEAN, overheating risks could come to the fore during the course of the year, which could necessitate rate hikes before the year is out.

Other than in Japan and Korea, we do not foresee large-scale fiscal stimulus in 2013. Policymakers in Korea appear poised for further fiscal measures to support growth, as part of the incoming President Park's economic policies, with a focus on social welfare projects and infrastructure. Elsewhere, Indonesia's 2013 budget is an example of the prudence displayed more widely: the budget projects a deficit of 1.6% of GDP in 2013 (after an outturn between 1.7% and 2.0% in 2012). Tax policies will also be used – Thailand's government will look to generate domestic demand through its tax-exemption policy for first-car buyers, while Malaysia will likely lower its income tax and increase the minimum wage – though its policies are constrained by the country's high fiscal deficit (5.0% in 2013 according to our estimates). Similar constraints will be felt in India, where recent efforts to implement much-needed policy reforms are resulting in authorities tackling the country's chronically high deficits.

Asian currencies (ex-Japan) under appreciation pressure from capital inflows

Falling global risk aversion and Asia's strong growth prospects are generating capital inflows to the region. This should continue to put upward pressure on currencies, especially in the second half of 2013 (Table 3). The ongoing depreciation trend of the Japanese yen is likely to continue, which may generate tensions with trading partners and cause some central banks to resist appreciation through currency intervention. At the same time, we expect the Chinese authorities to allow modest further appreciation in 2013, or around 2-3% against the USD.

4. Risks are becoming more balanced

After successive quarters of emphasizing downside risks to the outlook, we now see risks as more broadly balanced. As noted in the ***Global Outlook***, tail risks to the global economy have receded, although they have not been eliminated. Furthermore, China has averted a hard landing, which should be a positive to both global and regional sentiment. In the event that renewed risks to the external environment do materialize, there is room for further policy support in most Asian economies as a buffer.

Within the region, downside risks emanate from geopolitical concerns, especially from the ongoing dispute between China and Japan. Tensions with North Korea remain a perennial threat, as evidenced by recent nuclear tests. In the macro area, we seek risks of currency tensions rising in the midst of the ongoing weakening of the yen. Expected capital inflows stemming from global liquidity and the region's strong growth prospects may further complicate monetary management in this environment. Risks of destabilizing asset bubbles (such as in Hong Kong's property market) and inflation could emerge. Reform momentum in India will also need to be watched closely.

There are also upside risks to the outlook. Stronger than expected growth in the US and China could lead to a more robust upturn in exports than currently envisaged. Indeed, robust domestic demand and lax macro policies are already generating overheating concerns in some of the ASEAN economies, especially in Indonesia and the Philippines. Finally, in some economies rapid credit growth will need to be watched, lest it become a burden to consumer and corporate balance sheets, with negative implications for asset quality in the years ahead.

5. Tables

Table 1
Macroeconomic Forecasts: Gross Domestic Product

(YoY% growth rate)	2010	2011	2012	2013 (F)	2014 (F)
U.S.	2.4	1.8	2.2	1.8	2.3
EMU	1.9	1.5	-0.5	0.3	1.3
Asia-Pacific	8.2	5.7	5.2	5.6	5.8
Australia	2.4	2.2	3.5	3.0	3.4
Japan	4.4	-0.7	2.0	1.7	1.7
China	10.4	9.3	7.8	8.0	8.0
Hong Kong	7.0	5.0	1.4	3.5	4.0
India	8.9	7.5	5.4	6.5	6.9
Indonesia	6.1	6.5	6.2	6.3	6.8
Korea	6.2	3.6	2.0	2.7	4.0
Malaysia	7.2	5.1	5.2	4.8	5.0
Philippines	7.6	3.9	6.6	6.0	5.6
Singapore	14.5	5.0	1.5	2.3	4.0
Taiwan	10.8	4.1	1.2	3.5	4.2
Thailand	7.8	0.1	6.4	4.5	5.2
Vietnam	6.8	5.9	5.0	5.8	6.3
Asia ex China	6.7	3.4	3.6	4.0	4.4
World	5.1	3.9	3.2	3.6	4.1

Source: CEIC and BBVA Research

Table 2
Macroeconomic Forecasts: Inflation (Avg.)

(YoY% growth rate)	2010	2011	2012	2013 (F)	2014 (F)
U.S.	1.6	3.1	2.0	2.1	2.2
EMU	1.6	2.7	2.5	1.6	1.5
Asia-Pacific	3.6	4.8	3.0	3.3	3.5
Australia	2.8	3.4	1.8	2.9	2.5
Japan	-0.7	-0.3	0.0	0.1	0.7
China	3.3	5.4	2.6	3.3	4.0
Hong Kong	2.3	5.3	4.0	4.2	3.7
India	9.8	9.2	7.5	6.6	5.6
Indonesia	5.1	5.4	4.6	5.1	5.5
Korea	3.0	4.0	2.2	2.6	3.3
Malaysia	1.7	3.2	1.7	2.6	2.7
Philippines	3.8	4.4	3.2	3.5	4.0
Singapore	2.8	5.2	4.5	3.4	4.0
Taiwan	1.0	1.4	1.9	1.8	1.9
Thailand	3.3	3.8	3.0	3.4	2.9
Vietnam	10.0	18.1	9.3	8.2	8.3
Asia ex China	3.7	4.3	3.3	3.3	3.2
World	3.8	5.2	4.1	3.9	3.9

Source: CEIC and BBVA Research

Table 3

Macroeconomic Forecasts: Exchange Rates (End of period)

		2010	2011	2012	2013 (F)	2014 (F)
EMU	USD/EUR	1.34	1.30	1.32	1.32	1.33
Australia	USD/AUD	1.02	1.02	1.04	1.09	1.10
Japan	JPY/USD	81.1	76.9	86.75	100.0	104.0
China	CNY/USD	6.61	6.30	6.23	6.10	5.95
Hong Kong	HKD/USD	7.77	7.77	7.75	7.80	7.80
India	INR/USD	44.7	53.1	55.0	52.5	52.0
Indonesia	IDR/USD	8996	9069	9793	9400	9200
Korea	KRW/USD	1126	1152	1064	1060	1000
Malaysia	MYR/USD	3.06	3.17	3.06	2.90	2.80
Philippines	PHP/USD	43.8	43.8	41.0	40.0	39.0
Singapore	SGD/USD	1.28	1.30	1.22	1.20	1.19
Taiwan	NTD/USD	29.3	30.3	29.0	28.7	28.2
Thailand	THB/USD	30.1	31.6	30.6	30.0	29.5
Vietnam	VND/USD	19498	21034	20840	22000	22000

Source: CEIC and BBVA Research

Table 4

Macroeconomic Forecasts: Policy Rates (End of period)

(%)	Current	2011	2012	2013 (F)	2014 (F)
U.S.	0.25	0.25	0.25	0.25	0.25
EMU	1.00	1.00	1.00	0.75	1.25
Australia	3.00	4.25	3.00	3.25	4.00
Japan	0.10	0.08	0.10	0.10	0.10
China	6.00	6.56	6.00	6.00	6.50
Hong Kong	0.50	0.50	0.50	0.50	0.50
India	7.75	8.50	8.00	7.00	6.50
Indonesia	5.75	6.00	5.75	5.75	6.00
Korea	2.75	3.25	2.75	2.75	3.25
Malaysia	3.00	3.00	3.00	3.25	3.50
Philippines	3.50	4.50	3.50	3.50	4.25
Singapore	0.40	0.45	0.40	0.40	0.40
Taiwan	1.88	1.88	1.88	1.88	2.13
Thailand	2.75	3.25	2.75	3.50	3.50
Vietnam	9.00	9.00	9.00	9.00	9.00

Source: CEIC and BBVA Research

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