BBVA Research

Asia Outlook

Second Quarter 2010

Economic Analysis

- Asia has been leading the global recovery, and we expect regional growth to accelerate in 2010 propelled by exports and improving domestic demand.
- Headline inflation is still generally low, but rising. Further monetary tightening measures will be needed to prevent overheating.
- We expect the region's currencies to strengthen due to strong growth prospects and capital inflows.
- The main downside risks stem from spillovers from Europe and the possibility of overheating in China. The challenge is to implement timely exists from stimulus, while maintaining sufficient support in the event of a downturn in the global environment.

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Publication Date: 18 May 2010

Summary

Asia has been leading the global recovery, and has re-emerged as the world's fastest growing region. Propelled by a further rebound in exports and improving domestic demand, growth momentum is gathering pace. We expect GDP growth for the region to increase to 5.8% in 2010 from 1.8% last year.

Although the patterns of recovery vary, virtually all of the region's economies are now benefitting from an upturn in growth momentum. While Asia's larger economies avoided contractions during the global downturn, the more export-oriented economies are experiencing V-shaped recoveries after steep plunges in output. External demand has been an important driver of growth, especially in the early stages of the recovery, and there are now increasing signs of self-sustaining domestic-led growth as well. Consumer and business indicators have risen, and unemployment, while still high by historical standards, is falling. Production and exports are above previous peak levels.

Headline inflation is still generally low, but rising, due to increases in food prices, the low comparison base from last year, and as spare capacity is reduced. Underlying pressures remain in check, with the exception of India and Vietnam, where inflation is running close to double-digit levels, well above the averages of the rest of the region.

The challenge for policy makers is to implement timely exits from stimulus to prevent overheating, while still providing support in the event of a downturn in the external environment. There is a risk that some countries may allow policies to remain too lax, thereby increasing inflationary pressures and overheating risks.

We expect further tightening measures in the period ahead. Monetary policy has already been tightened in a number of countries, including Australia, China, India, Malaysia, and Vietnam through hikes in interest rates and/or measures to drain liquidity, and in Singapore through an appreciation of its exchange rate band. A number of countries, including China, Hong Kong, Korea, and Singapore have also taken steps to curb speculation in property markets. Fiscal policy stances generally remain supportive of growth, although most countries are aiming for smaller deficits in 2010.

We expect the region's currencies to strengthen due to improving growth prospects and capital inflows. These trends could accelerate if the Chinese RMB is allowed to appreciate at a faster pace than anticipated in our baseline. Further capital inflows could pose a challenge to policy makers by generating additional appreciation pressures and putting upward pressure on already inflated asset prices.

The main risks to the outlook are from the external environment. While growth momentum remains intact in emerging market economies and in the U.S, uncertainties have risen in Europe with prospects of spillovers. The possibility of overheating in China also poses risks. The risk of mild form of overheating in China is rising, in which inflationary pressures and asset price bubbles could necessitate further measures to cool the economy. In a more extreme, but less likely "boom-bust" scenario, there could be a loss of investor confidence and a more abrupt decline in growth. Within the region, Thailand faces its own set of challenges from the ongoing political unrest, while Vietnam has been struggling to maintain macroeconomic stability in the face of large fiscal and current account deficits.

1. Asia has been benefiting from a strong recovery of global trade, although the external environment remains challenging

The global economy is driven by two conflicting forces: the positive cyclical impulse from emerging countries and the US, and heightened risk premia spreading from Europe. While the EMU rescue package reduces uncertainties in the short-run, the balance of risks over the medium-term remains tilted to the downside

The cyclical situation has improved significantly over the last few quarters, driven by the recovery in emerging market economies and the US. Global trade is growing at 7% and we forecast 4.2% global growth for 2010. At the same time, there are doubts about the ability of the European Monetary Union within its current decision-making framework to deal with the high level of indebtedness of some of its countries. These doubts have given rise to widening spreads and renewed financial stress. Such developments may impinge first on the European economy with possible spillovers to the rest of the world. The timing and the extent of these adverse impacts will crucially hinge on the effectiveness and lasting effects of the announcement of the rescue package agreed by the European Council on May 9 and the exceptional measures adopted by the ECB. While the package has stabilised market conditions in the short-run, uncertainties remain in three main areas: i) the implementation of the rescue package in the months to come, ii) the credibility of further fiscal consolidation to be adopted by some EU countries and iii) EMU core countries' medium-term commitment to the package.

Following the short-term impulse from unprecedented fiscal and monetary expansion worldwide, the sustainability of the recovery is not fully guaranteed beyond 2010, mainly in developed countries

While economic recovery in early 2010 has been widespread, its intensity has varied a great deal across countries. This is the result of different degrees of laxness in their fiscal and monetary policies. These policies have been particularly instrumental in providing impulse to the cyclical upturn in China and the US. At the same time, emerging economies are benefiting from the strength of their own domestic demand. As a result, in these economies the recovery looks more likely to be self-sustained. Conversely, in developed countries, as expansionary policies fade away, doubts about the sustainability of the recovery beyond 2010 are growing.

Growing divergence in monetary exit strategies looking ahead: a gradual approach in the US; no clear timing for the exit in EMU; and no a one-size-fits-all strategy across emerging markets

A very gradual path of interest rates hikes by the Fed is forecast. Rate hikes by the Fed are not expected until the beginning of 2011, with rates rising slightly above 1% by the end of 2011. There are major differences in the economic backgrounds in the US and Europe that will lead to different monetary developments in both areas. Although economic growth may prove sluggish in 2010 and beyond, the risk of a major reversion of current dynamics is rather limited in the US, with incipient inflationary pressures looming. Conversely, in Europe, in addition to a far more fragile financial situation, the upturn looks more uncertain and inflationary pressures are absent. In the case of emerging economies' monetary policies, there is no doubt about the need for a tightening stance. Given their cyclical divergences, exit strategies will vary across countries. In some countries, if the tightening of monetary policy and other measures are not implemented soon, macroeconomic imbalances will build up.

Markets have shown the limits of anticyclical fiscal policies. Economies with high public debt and limited private deleveraging are highly vulnerable to an upward movement in interest rates and higher risk premia

During period of heightened risk aversion, financial markets are particularly good at tracking inconsistent macroeconomic policies, which might otherwise be overlooked in normal times. Despite the huge rescue package in Europe, substantial risk premia should prevail in the market amid uncertainty on the fiscal consolidation path. Increasing contagion has been clear evidence of the fragility of the current scenario. Economic history is fraught with examples of undue contagion from some countries to others in the aftermath of a crisis. In these cases, geographical linkages or cyclical similarities often matter more than differences in fundamentals. In fact, the current episode of contagion appears not to be fully justified either by the direct financial channel triggered by the Greek crisis or by any similarities in fundamentals. Though its justification may be open to debate, to cope with pressures from international investors, there is a compelling need for some countries to enhance credibility..

Long-run fiscal consolidation is the major challenge for developed countries

There are growing concerns about the long-term consequences of the build-up in public debt. This will unavoidably give rise to upward pressures on real interest rates and high risk premia for a protracted period. Even if recent contagion gradually fades, increasing discrimination across countries depending on the credibility of their fiscal stance will prevail.

The lack of a decisive restructuring in the banking sector and the coming regulatory process poses risks to the recovery

Uncertainty stemming from the financial sector is primarily twofold. The sluggish restructuring of the financial industry, particularly in Europe, will lead to a creditless recovery. This is a growing concern since both historical episodes and empirical evidence show the importance of the credit channel in the early stages of the economic upswing. There is also lot of uncertainty regarding the ongoing regulatory reform. The most likely outcome is one of a significant increase in capital and liquidity requirements. This could hinder the ability of the banking sector to grant credit in coming years.

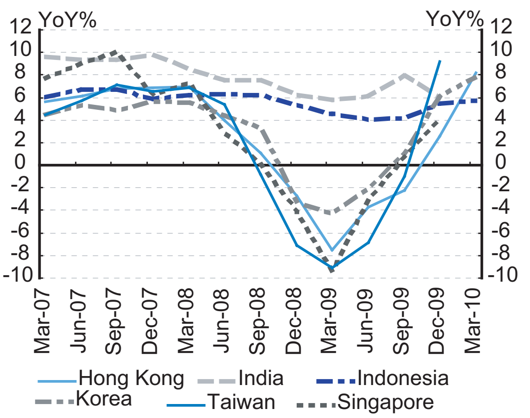
2. Asia is leading the global recovery

Asia has been leading the global recovery, and has re-emerged as the world's fastest growing region. Although the pattern of recovery has varied—the more domestically focused economies avoided contractions (China, India, and Indonesia), while the more export oriented ones witnessed V-shaped recoveries following steep plunges in output (Korea, Hong Kong, Singapore, and Taiwan)—in most countries output and exports had returned to pre-Lehman levels by the fourth quarter of 2009 (Chart 1). More recently, growth momentum has accelerated, with quarterly GDP outturns surprising to the upside in most cases.

Rising growth momentum has been led by policy stimulus and external demand

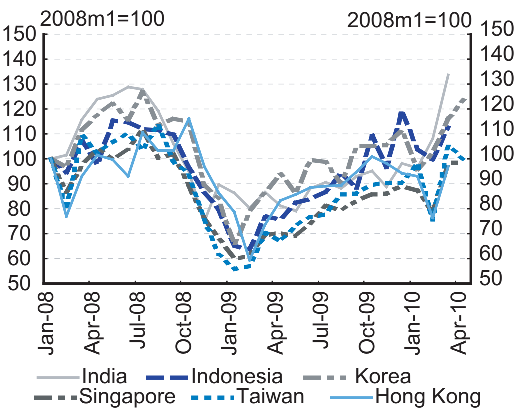
Recoveries were initially led by stimulus packages and strong demand from China (see China Outlook). The latter was induced by China's massive spending package which, given its emphasis on infrastructure, generated demand for commodities and primary goods (benefitting Australia and Indonesia in particular); rising incomes and subsidies to stimulate domestic consumption also resulted in demand for final goods including autos and electrical appliances (benefitting Korea). As the global recovery gathered pace, demand for processing inputs (electrical components) from China increased (benefitting both Korea and Taiwan). Export demand began to broaden out regionally by Q3 2009, benefitting all of Asia's economies, including Southeast Asia, which had been left behind during the early stages of the recovery (Chart 2).

Chart 1
GDP growth of selected Asian economies



Source: CEIC and BBVA Research staff estimate

Chart 2
Export values are near or above pre-crisis levels



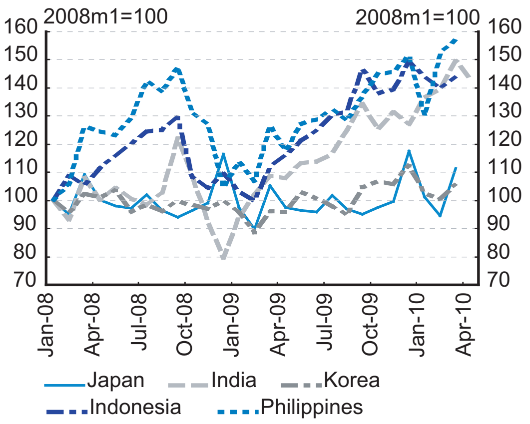
Source: CEIC and BBVA Research staff estimate

A strong pickup in domestic demand is now raising prospects of self-sustaining recoveries, with many countries, to vary degrees, implementing exit strategies from policy stimulus

More recently, growth has been propelled not only by a recovery in exports, but by domestic demand as well, thereby enhancing prospects for self-sustaining recoveries. Private consumption in particular has been robust, thanks to improving labor market conditions, wealth effects from the rebound in asset prices, and strong consumer sentiment (Chart 3 & 4). Steadily improving business sentiment and inventory restocking, together with a pickup in credit growth, is also leading to an increase in investment spending (Chart 5). With the inventory cycle far from over, prospects for Asia to continue leading the global recovery are good.

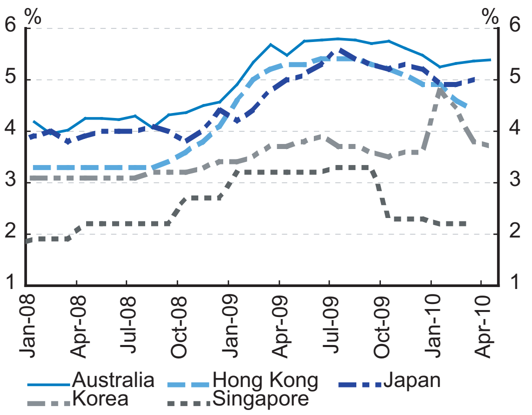
Rapidly closing output gaps and worries about asset price bubbles in some parts of the region have prompted national authorities to begin implementing exit strategies from their accommodative policies. Countries furthest ahead in the recovery process (e.g. Australia) are correspondingly ahead in implementing their exits.

Chart 3
Retail sales are trending up



Source: CEIC and BBVA Research staff estimate

Chart 4
Unemployment rates are still relatively high, but falling

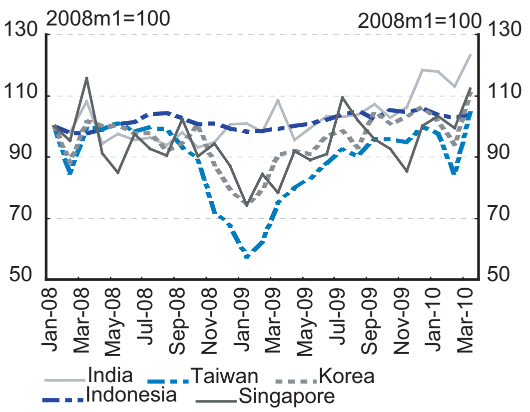


Source: CEIC and BBVA Research

Inflation is a rising concern, prompting some central banks to begin tightening monetary policy

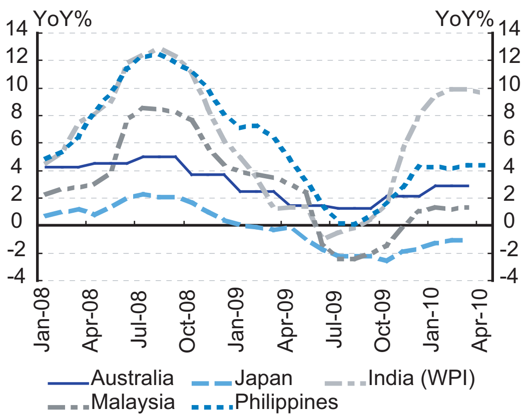
Up until now, inflation has been of only minor concern in most countries. India and Vietnam are exceptions, where rising food and fuel prices have pushed inflation to near double-digit levels. Japan, meanwhile, lies at the other end of the inflationary spectrum, with the persistence of outright deflation. Elsewhere around the region, inflation has been gradually rising, but remains well within central bank target ranges (Chart 6). In addition to spare capacity, currency appreciation has helped to dampen inflation.

Chart 5
Industrial production has risen above pre-crisis levels



Source: CEIC and BBVA Research staff estimate

Chart 6
CPI inflation remains subdued for the most part



Source: CEIC and BBVA Research

On the monetary policy front, Australia has been the most aggressive central bank in the region, having essentially normalized its monetary stance by raising interest rates six times since October 2009, by a cumulative 150bps to 4.5%, near its long-term average. India and Vietnam, as noted above, have also begun tightening policy to contain inflationary expectations. India has so far raised its cash reserve requirement by 100bp (last February), and interest rates by 50bp (in March and April); Vietnam raised interest rates by 100bp last December. Within its exchange rate based monetary framework, Singapore tightened policy last month by shifting the center of its undisclosed band to a more appreciated level and by announcing a gradual appreciation path. Malaysia, meanwhile, has implemented two 25bp hikes in rates.

Other central banks have begun withdrawing liquidity through open market operations, and several of them have signaled that they may soon begin to raise rates. Despite the strong recovery, the Bank of Korea, notably, has so far refrained from hiking rates from their exceptionally low level of 2%, largely because of concerns about the global economy, but appears set to do so during the second half of the year. With domestic demand still weak and deflation an ongoing concern, Japan, appropriately, continues to maintain interest rates at levels close to zero.

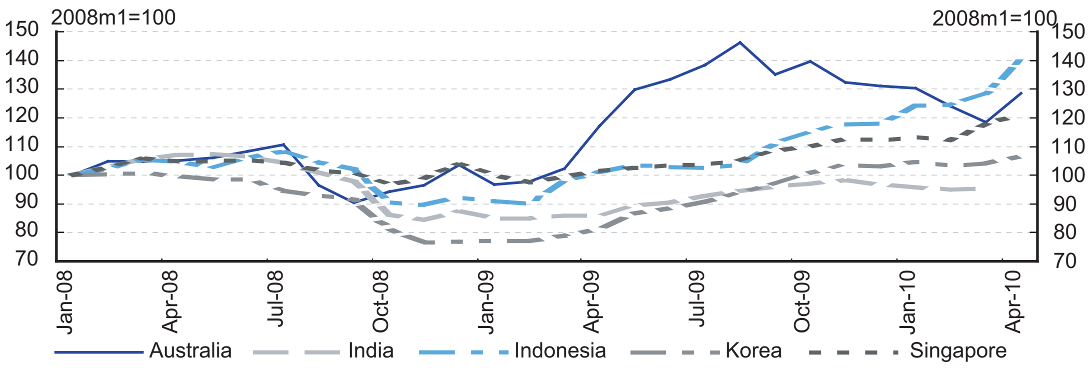
Fiscal policies generally remain supportive across the region, often with a focus on job creation and social spending. That said, there has been some withdrawal of stimulus due to a slowdown in the pace of spending compared to 2009.

Asian currencies are under appreciation pressure due to strong growth prospects and balance of payments surpluses

Beyond monetary policy instruments, currency appreciation across the region has resulted in some tightening of monetary conditions. Appreciation pressures have mounted due to large current account surpluses in many economies, and strong capital inflows to the region. A number of central banks have been slowing the pace of appreciation through sizeable foreign exchange intervention, and correspondingly reserve levels have risen sharply (Chart 7).

Chart 7

Foreign reserves are rising



Source: CEIC and BBVA Research staff estimate

3. Our projections are being revised upward due to the region's strong growth momentum, aided by improving external and domestic demand

With growth momentum strengthening, Asia's economic outlook remains bright and we are raising our growth forecasts (Table 1). Despite risks to the global outlook, export demand is expected to stay resilient, not only because of demand from China, but because of the ongoing global and regional restocking process that still has some quarters to run. We anticipate some moderation of growth in the second half of the year as policy stimulus is withdrawn and as the boost from the global inventory cycle begins to wear off. Overall, we forecast the region's GDP growth to rise to 5.8% in 2010 from 1.8% last year.

Outside of China, India's projected growth in 2010 is expected to be especially strong, at 8.0%, on robust domestic demand. Domestic consumption is strengthening due to improvements in labor market conditions, and private investment spending is rising on higher business profitability. Growth rates in Asia's export-oriented economies are also projected to be very strong, led by Singapore (8.3%) and Taiwan (7.4%).

While generally still modest, inflationary pressures are on the rise

Underlying inflationary pressures remain modest in most countries given the existence of still positive, albeit rapidly narrowing, output gaps. India and Vietnam are exceptions, where we expect average inflation for the year to be close to 10% given recent trends and the impact of rising food prices. For the rest of the region, we expect a modest upturn in headline inflation on account of the narrowing output gaps and rising employment trends. In Japan, however, we anticipate overall inflation in 2010 to remain negative (Table 2).

Currencies are expected to strengthen due to robust growth prospects and capital inflows

Improving growth prospects and renewed capital inflows have resulted in significant currency appreciation across the region. We expect the region's currencies to strengthen, although the pace of appreciation is likely to moderate as central banks slow the pace through FX intervention (Table 3).

Appreciation trends could accelerate, however, if the Chinese RMB is allowed to appreciate at a faster pace than anticipated in our baseline. Further capital inflows could pose a challenge for policy makers by generating further appreciation pressure and putting upward pressure on already inflated asset prices. Heightened risk aversion from recent developments in Europe has, at least temporarily, eased capital inflow pressures.

Withdrawal of stimulus is expected, but with maintenance of overall supportive policy stances due to risks to the global outlook

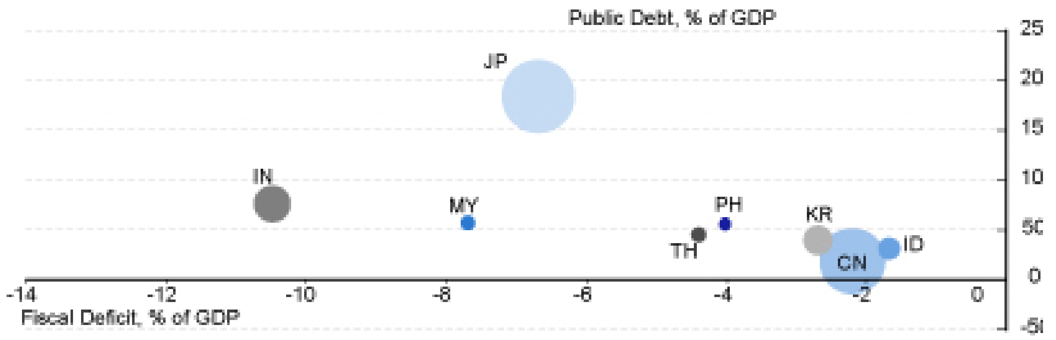
Given the strong growth momentum and rising inflationary trends, attention has shifted to exit strategies. Even as stimulus is gradually withdrawn, however, most countries plan to maintain accommodative fiscal and monetary policies to ward off risks of a double dip recession abroad.

On the monetary policy front, we expect stances to remain accommodative for the most part, but with a normalization of interest rates from their exceptionally low levels of last year. We anticipate only one more rate hike in Australia and Malaysia during the remainder of the year, with Korea the next central bank, in our view, to begin hiking rates by up to 100 bps during the rest of the year. Ongoing uncertainties from the European debt crisis, however, could affect the timing and magnitude of rate hikes. Given the sluggish pace of recovery in Japan, we do not forsee interest rate hikes until 2011. We also do not anticipate rate hikes in Indonesia during the course of the year given its relatively high nominal rate, and steady inflation, or in Taiwan, which typically does not move ahead of the US Fed (Table 4).

Fiscal policies are expected to remain supportive during remainder of 2010. With growth momentum so strong, most fiscal authorities are aiming to narrow their budget deficits in 2010 and beyond. In any case, Asia's fiscal balances and public debt ratios are generally healthy (Chart 8). India is one of the few countries in Asia with sustained fiscal deficits and high debt levels, and to address this, it has announced a deficit reduction plan over the coming years. Japan also has a very high public debt ratio, but given its dependence on domestic financing, the sustainability of its fiscal position is not a significant concern.

Chart 8

Fiscal positions of most Asian countries are healthy



Source: CEIC and BBVA Research

4. Risks stem from uncertainties in Europe and, to a lesser extent, prospects of overheating in China

Recent growth momentum, strengthening domestic demand, and strong underlying fundamentals make Asia generally well-placed to weather external risks. Risks of spillovers from ongoing developments in Europe have renewed the potential for a slowdown in global demand, which could have an adverse impact on exports. Tighter global financing conditions could also raise the cost of borrowing for the region's corporates. That said, direct contagion effects should be limited given Asia's sound public finances.

Risks from overheating in China also present a downside risk to Asia's outlook. Such risks are still low in our view, but are rising, especially of a mild form of overheating in which rising inflationary pressures and asset price bubbles could necessitate further measures to cool the economy. In a more extreme, but less likely "boom-bust" scenario, there could be a loss of investor confidence and a more abrupt decline in growth. A sharp decline in China's commodity demand could have an adverse impact on the region's commodity exporters (particularly Australia and Indonesia), while the region's export-oriented economies, for whom China has become the largest export destination, would also be vulnerable in such a scenario. Within the region, Thailand faces challenges of its own from ongoing political unrest, while Vietnam has been struggling to maintain macroeconomic stability in the face of large fiscal and current account deficits.

On the domestic front, although inflationary risks and property price bubbles are contained for the time being, they do bear watch. Policymakers face the challenge of withdrawing policy stimulus to avert overheating risks, while being mindful of maintaining sufficient support in the event that risks to the external outlook materialize. A resurgence of capital inflows driven by the region's relatively strong growth prospects could also pose a challenge to monetary management.

5. Tables

Table 1

Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2007	2008	2009	2010 (F)	2011 (F)
U.S.	2.1	0.4	-2.4	3.0	2.5
EMU	2.7	0.5	-4.0	0.7	1.3
Asia-Pacific	7.3	4.0	1.8	5.8	5.3
Australia	4.7	2.4	1.3	3.0	3.1
Japan	2.4	-1.2	-5.1	1.6	1.4
China	13.0	8.9	8.7	9.8	9.2
HK	6.4	2.1	-2.7	5.0	4.7
India	9.5	7.4	6.4	8.0	7.5
Indonesia	6.3	6.0	4.5	5.5	6.0
Korea	5.1	2.3	0.2	5.0	4.5
Malaysia	6.2	4.6	-1.7	5.0	5.0
Philippines	7.1	3.8	0.9	3.5	4.6
Singapore	8.2	1.4	-2.0	8.3	4.5
Taiwan	6.0	0.7	-1.9	7.4	4.5
Thailand	4.9	2.5	-2.3	4.2	4.3
Vietnam	8.5	6.2	5.3	6.5	6.9
Emerging Asia ex China*	5.1	2.1	-0.8	4.2	3.8
World	5.3	3.0	-0.7	4.2	4.1

* Excluding Japan and Australia
Source: BBVA Research

Table 2

Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2007	2008	2009	2010 (F)	2011 (F)
U.S.	2.9	3.8	-0.4	2.0	1.8
EMU	2.1	3.3	0.3	1.0	1.2
Asia-Pacific	2.8	4.9	0.2	2.9	2.6
Australia	2.3	4.4	1.8	2.6	2.6
Japan	0.1	1.4	-1.4	-0.8	-0.5
China	4.8	5.9	-0.7	3.1	3.3
HK	2.0	4.3	0.5	3.3	3.0
India	4.8	9.1	2.2	9.6	6.8
Indonesia	6.0	9.8	4.8	5.1	5.7
Korea	2.5	4.7	2.8	2.9	3.0
Malaysia	2.0	5.4	0.7	2.4	2.5
Philippines	2.8	9.3	3.3	5.0	4.4
Singapore	2.1	6.5	0.2	2.8	2.5
Taiwan	1.8	3.5	-0.9	1.5	1.7
Thailand	2.2	5.5	-0.8	3.5	3.0
Vietnam	8.3	23.1	7.0	9.5	7.0
Emerging Asia ex China*	2.1	4.6	0.6	2.8	2.4
World	4.1	6.1	2.2	3.7	3.4

* Excluding Japan and Australia
Source: BBVA Research

Table 3

Macroeconomic Forecasts: Exchange Rates (End period)

		2007	2008	2009	2010 (F)	2011 (F)
U.S.	EUR/USD	0.70	0.70	0.70	0.80	0.80
EMU	USD/EUR	1.40	1.50	1.40	1.30	1.20
Australia	USD/AUD	0.87	0.67	0.90	0.93	0.90
Japan	JPY/USD	112.5	96.1	90.8	95.0	100.0
China	CNY/USD	7.30	6.83	6.83	6.54	6.30
HK	HKD/USD	7.80	7.75	7.75	7.80	7.80
India	INR/USD	39.4	48.6	46.8	44.0	43.3
Indonesia	IDR/USD	9334	10838	9470	9000	9000
Korea	KRW/USD	931	1364	1166	1050	1000
Malaysia	MYR/USD	3.33	3.56	3.40	3.20	3.10
Philippines	PHP/USD	41.7	48.3	46.8	45.0	45.0
Singapore	SGD/USD	1.45	1.49	1.39	1.35	1.33
Taiwan	NTD/USD	32.4	33.0	32.3	31.0	30.0
Thailand	THB/USD	30.2	34.8	33.3	32.0	32.0
Vietnam	VND/USD	16114	16977	17941	19500	20200

Source: BBVA Research

Table 4

Macroeconomic Forecasts: Policy Rates (End period)

	2007	2008	2009	2010 (F)	2011 (F)
Australia	6.8	4.3	3.8	4.8	5.5
Japan	0.5	0.1	0.1	0.1	0.5
China	7.5	5.3	5.3	5.9	6.4
HK	3.3	0.9	0.1	0.1	1.1
India	7.8	6.5	4.8	6.5	7.5
Indonesia	8.0	9.3	6.5	6.5	7.5
Korea	5.0	3.0	2.0	3.0	4.0
Malaysia	3.5	3.3	2.0	2.8	3.0
Philippines	5.5	5.9	4.0	4.5	5.0
Singapore	2.4	1.0	0.7	0.7	1.7
Taiwan	3.4	2.0	1.3	1.3	2.3
Thailand	3.3	3.4	1.3	1.8	2.0
Vietnam	8.3	8.5	8.0	8.5	7.5

Source: BBVA Research

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